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This Financial System Stability Assessment on Serbia was prepared by a staff team of the International Monetary Fund and the World Bank 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 January 17, 2006. The views expressed in this document are those of the staff team and do not necessarily reflect the views of the government of Serbia or the Executive Board of the IMF.

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SERBIA AND MONTENEGRO

Serbia—Financial System Stability Assessment

Prepared by the Monetary and Financial Systems and European Departments

Approved by Michael Deppler and Ulrich Baumgartner

January 17, 2006

This Financial System Stability Assessment (FSSA) is based on work of the Financial Sector Assessment Program (FSAP) team, whose two main missions to Belgrade were in March and April 2005. The FSAP findings were further discussed with the authorities during the mission for the sixth review of the Extended Arrangement in October 2005.

The FSAP team comprised Mark Stone (Mission Chief, IMF), Michael Edwards (Deputy Mission Chief, World Bank), Marie Thérèse Camilleri, Vania Etropolska, In Won Song, Neil Saker, Andreas Westphal, and Charmane Ahmed, mission assistant (all IMF); Peter Kyle, Rodney Lester, Susan Marcus, Angela Prigozhina, Branko Radulovic, Susan Rutledge, and Martin Slough (all World Bank); and Tom Kokkola, Ronald MacDonald, and Walter Zunic (all experts). The FSAP team received excellent cooperation from the authorities.

The main findings of the FSAP are:

- The transformation of Serbia's financial system is bringing important benefits, but there are emerging signs that the rapid pace of credit growth is beginning to erode financial stability.
- The main potential threat to financial stability is indirect credit risk arising from the large share of bank lending effectively denominated in foreign exchange.
- A decline in the profitability of foreign banks seeking to gain market share, coupled with an adverse shock—especially an unexpected depreciation, could ultimately result in a credit crunch.
- Although the authorities have implemented an array of measures in support of financial stability, further reforms are warranted in the areas of bank supervision and the financial infrastructure.
- An improved monetary policy and liquidity framework would also enhance stability, as well as make monetary policy more effective.

This report was prepared by Mark Stone and Neil Saker, based on the work of the FSAP team.

FSAPs 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. FSAPs do not cover risks that are specific to individual institutions such as asset quality, operational or legal risks, or fraud.

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GLOSSARY

AML	Anti-money laundering
APML	Administration for the Prevention of Money Laundering
BCP	Basel Core Principle
CP	Core Principle
CAMEL	Capital Assets Management Earnings and Liquidity
CAR	Capital adequacy ratio
CEE	Central and Eastern European
CFT	Combating the Financing of Terrorism
CPSIPS	Core Principles for Systemically Important Payment Systems
CSDCHS	Central Securities Depository and Clearing House of Serbia
DIA	Deposit Insurance Agency (formerly the Bank Rehabilitation Agency)
DIS	Deposit insurance scheme
EBRD	European Bank for Reconstruction and Development
EU	European Union
FSAP	Financial Sector Assessment Program
GDDS	General Data Dissemination System
GDP	Gross Domestic Product
IAS	International Accounting Standards
IFRS	International Financial Reporting Standards
IPO	Initial Public Offering
ISD	Insurance Supervision Department
IT	Information technology
LOB	Law on Banks
LOLR	Lender of last resort
MEFP	Memorandum on Economic and Financial Policies
MOF	Ministry of Finance
MOJ	Ministry of Justice
MONEYVAL	The Select Committee of Experts on the Evaluation of Anti–Money Laundering Measures of the Council of Europe
MTPL	Motor third-party liability
NOS	National Office of Statistics
NPL	Nonperforming loan
OTC	Over-the-counter
PLC	Paris and London Clubs
ROA	Return on Assets
ROE	Return on Equity
RTGS	Real-time gross settlement
SC	Securities Commission
SDDS	Special Data Dissemination Standard
SME	Small and medium-size enterprise
SRD	Serbian dinar
SRR	Statutory reserve requirements
T-bill	Treasury bill

EXECUTIVE SUMMARY

1. **The ongoing transformation of Serbia's financial system is bringing important economic benefits.** The entry of foreign banks in recent years has led to a sharp increase in intermediation with credit to the private sector now expected to grow by close to 10 percent of GDP in 2005 alone. As a result, the financial system is much better able to support economic growth.

2. **However, there are emerging signs that the rapid pace of credit growth is beginning to erode financial stability.** The legacy of macroeconomic instability, negative real interest rates and the stable exchange rate regime has led to a high level of euroization. Thus, almost all new bank loans are effectively in euro. However, the earnings of most borrowers are in dinar. This combination leaves borrowers, and indirectly the banks, vulnerable to an unexpected depreciation. Further, the NPLs of the foreign banks seem to be on an upward trend. A decline in the profitability of foreign banks striving to gain market share, coupled with an adverse shock—especially a depreciation, could ultimately result in a credit crunch. Separately, the weak balance sheets and poor governance of the remaining large state-controlled banks leaves them vulnerable in the run up to their privatization.

3. **Policy measures to move Serbia further toward international best practices would mitigate the risks to financial stability** (Box 1). The assessment of Basel Core Principles raised a number of deficiencies in bank supervision. The Law on Banks passed in November 2005 provides the legal framework for addressing many of these shortfalls. The next steps to improve supervision would be to: rapidly implement the new Law on Banks, fully adopt risk-based supervision, further boost institutional capacity, and improve bank governance. Rapid privatization of the large-state controlled banks would ameliorate the potential risks that they pose. The authorities are also implementing a number of macroprudential measures to contain credit growth with a view to limiting the large current account deficit and reducing inflationary pressures. The effectiveness of these measures in slowing credit growth, and even more so in improving credit quality, cannot be relied on. Therefore, they should be complemented by tightened fiscal, monetary and income policies, and by real sector structural reforms.

4. **An upgrading of the monetary policy and systemic liquidity framework would help mitigate financial vulnerabilities and improve policy effectiveness.** Monetary transparency is improving and the payment system is excellent. However, monetary operations should become more market-based, a market-based interest rate corridor established, and the lender of last resort facilities refined to meet international best practice.

5. **The uneven development of the financial sector is not conducive to financial stability and the provision of financial services.** The small insurance sector needs to be rationalized and developed by the resolution of the remaining nonviable insurers and privatization of the two largest socially owned insurance companies. Capital markets must be built virtually from scratch by establishing a modern infrastructure and improving corporate governance.

Box 1. Summary of Key Policy Recommendations

Short-term measures

- Establish by-laws and make the regulatory changes called for under the new Law on Banks.
- Fully adopt risk-based supervision and improve supervisory capacity.
- Complete the move to market-based single interest rate monetary policy operations.
- Privatize the remaining two large state-controlled banks

Longer-term measures

- Complete resolution of nonviable insurers and privatize the two large socially owned insurance companies.
- Enhance the transparency of ownership and control of traded companies.
- Improve the legal framework and enhance capacity of the auditing and accounting professions.
- Implement the corrective action plan for AML/CFT recommendations put forward in the MONEYVAL report.

I. The Macroeconomic Setting and the Structure of the Financial Sector

6. **The turbulence of the 1990s led to massive disintermediation in the context of a halving of real GDP**. Politically distorted and conflict driven economic management created large fiscal and external imbalances, resulting in hyperinflation and heavy debt. The effective freezing of the bulk of foreign currency savings deposits of households and large bank pyramid schemes led to the loss of households' savings. Socially owned enterprises faced soft budget constraints and received easy financing from banks. Financial depth was brought down to about half the level of the 1980s.

Recently, progress toward macroeconomic stability has slowed and euroization risen

7. **The initial gains in stabilization have stalled and two macroeconomic vulnerabilities are raising concerns.** First, 12-month inflation remains persistently high and reached 18 percent in November 2005, reflecting strong domestic demand driven by rapid credit growth, as well as higher international energy prices and administrative price increases. Second, the current account deficit relative to GDP remains very high at an expected 10.2 percent in 2005. The macroeconomic imbalances are, to a considerable degree,

rooted in the limited restructuring and weak financial discipline in the state-and socially owned enterprises.

8. **Euroization continues to rise, weakening the transmission of monetary policy**. The share of euro-denominated bank liabilities rose from 55.9 percent in 2003 to 68.7 percent in September 2005, partially as the result of negative real interest rates on dinar deposits in the context of a tightly managed exchange rate regime. Euroization undermines the effectiveness of changes in monetary policy interest rates on bank lending rates; thus, the NBS has resorted to altering statutory reserve requirements (SRRs) to effect changes in monetary conditions and is using macroprudential measures to slow down credit growth.[1]

Foreign banks have supplanted state-owned banks

9. **The banking sector is undergoing a fundamental transition from a state controlled to a private foreign-owned system**. Licensed banks numbered 41 as of September 2005 with assets equivalent to about 40 percent of GDP (Table 1 and Figure 1). At the same time, the state banking sector is rapidly diminishing. In January 2002, the four dominant state banks were resolved, and soon after another 19 smaller banks were closed. The government initiated a debt-for-equity swap on bank loans from the Paris and London Club creditors that resulted in a de facto renationalization of a large share of the banking system. Most of the foreign banks entered after 2001 either through greenfield investments or by acquisition of existing Serbian banks, raising the foreign share of total banking assets to 63 percent as of September 2005. Austrian banks have been the major players, followed by Italian, French and Greek banks.

Bank credit is expanding rapidly

10. **Credit growth is being driven by high demand from a low base and by the foreign banks' quest to gain market share.** The flow of credit to the private sector amounted to 6.4 percent of GDP in 2004 and in late 2005 rose to a pace of 1.5 percent of GDP per month (Table 2). Credit demand is driven by strong real growth and the still low level of bank intermediation. Banks are financing credit from steady increases in euro-denominated deposits, reflecting improved confidence in the banking system, as well as borrowings from headquarters of foreign banks. Foreign banks with relatively easy access to capital and experience in the region have ambitious plans for expansion in the context of high interest rate margins and the potential for further growth. Rapid credit growth from a low base is in line with that of other Central and Eastern European (CEE) countries (Box 2). Overall, banks have a healthy amount of capital but NPLs seem to have been on the rise during 2005 (Appendix I).

[1] In this report, macroprudential measures refers to those that are addressed mainly at macroeconomic stability and are usually administrative; they can be contrasted to traditional prudential/supervisory or macroeconomic measures.

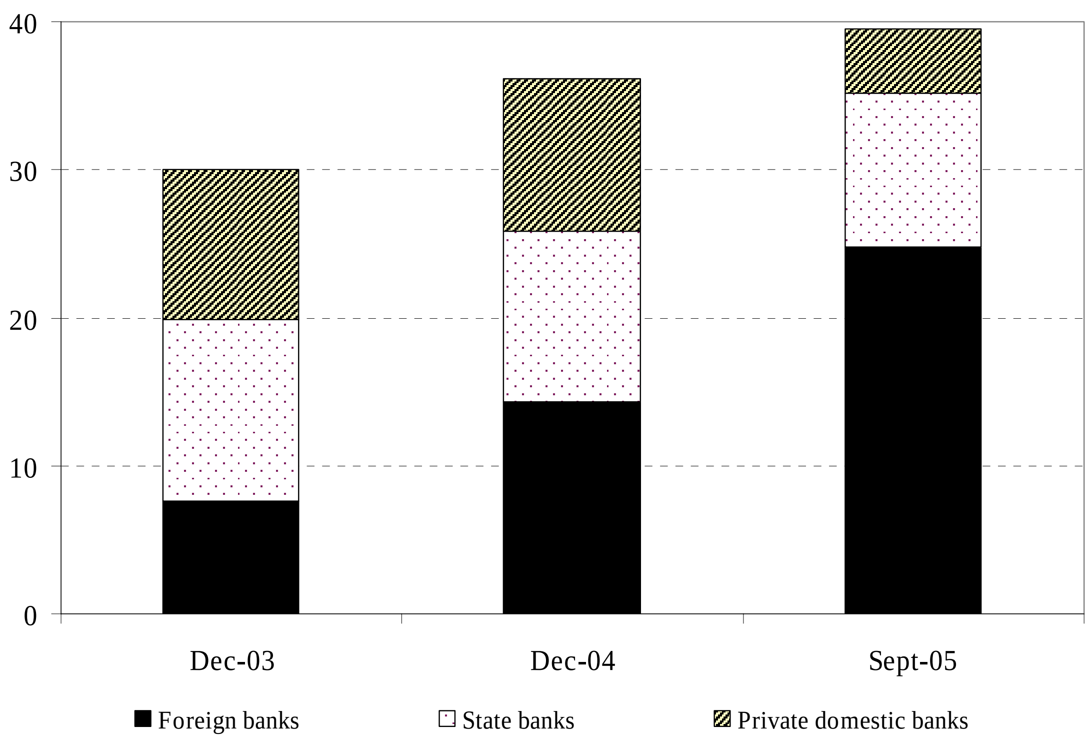
Table 1. Financial System Structure, 2001–04

	2001	2002	2003	2004
Number of banks	86	50	47	45
Total assets (in million Euro) 1/	14,939	5,391	5,481	6,980
Assets in percent of GDP	126	36	30	36
Number of insurance companies	33	36	39	22
Total premiums (in million Euro)	291	350	330	294
Premiums in percent of GDP	2	2	2	2
Number of leasing companies	-	1	6	26
Total assets (in million Euro)	...	...	31	350
Assets in percent of GDP	...	...	0	2

Sources: NBS, Ministry of Economy, Department of Insurance Supervision, and staff estimates.

1/ The large decline from 2001 to 2002 reflects the inflated valuation of the assets of four large state-owned banks that were resolved during 2002.

Figure 1. Bank Assets to GDP by Ownership



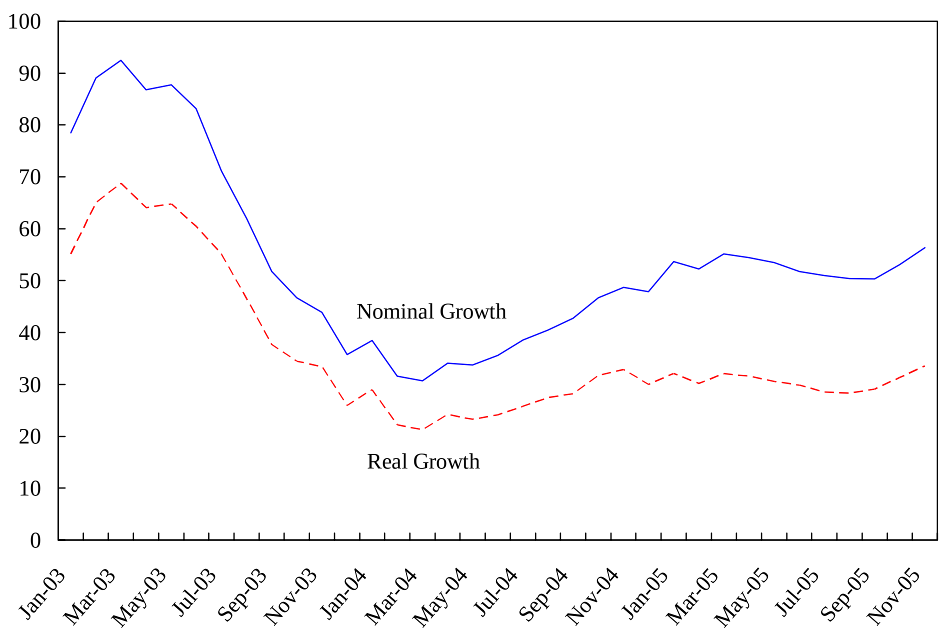
Source: DIA.

Table 2. Sources and Uses of Bank Funds, 2004–05
(Flows in percent of GDP)

	2004 Total	2005 Q1-Q3
Sources of funds		
Foreign exchange deposits	4.3	4.2
Banks' foreign borrowing (net)	4.1	2.8
Dinar deposits	0.9	1.7
Capital	0.8	1.4
Other items net	-0.3	-0.2
Total	9.8	9.8
Uses of funds		
Credit to private sector	6.4	5.4
Required reserves	2.0	2.9
NBS bills and repos	-0.1	1.1
Credit to public enterprises	0.4	0.4
Credit to government	1.0	0.2
Free reserves	0.0	-0.2
Total	9.8	9.8
Memorandum items:		
Direct corporate borrowing from nonresidents	3.1	2.9
Leasing companies turnover	1.5	1.3

Sources: NBS and staff estimates.

Figure 2. Credit Growth: Nominal and Real Year-on-Year Change



Source: NBS.

Box 2. Credit in Serbia Compared with other CEE Countries

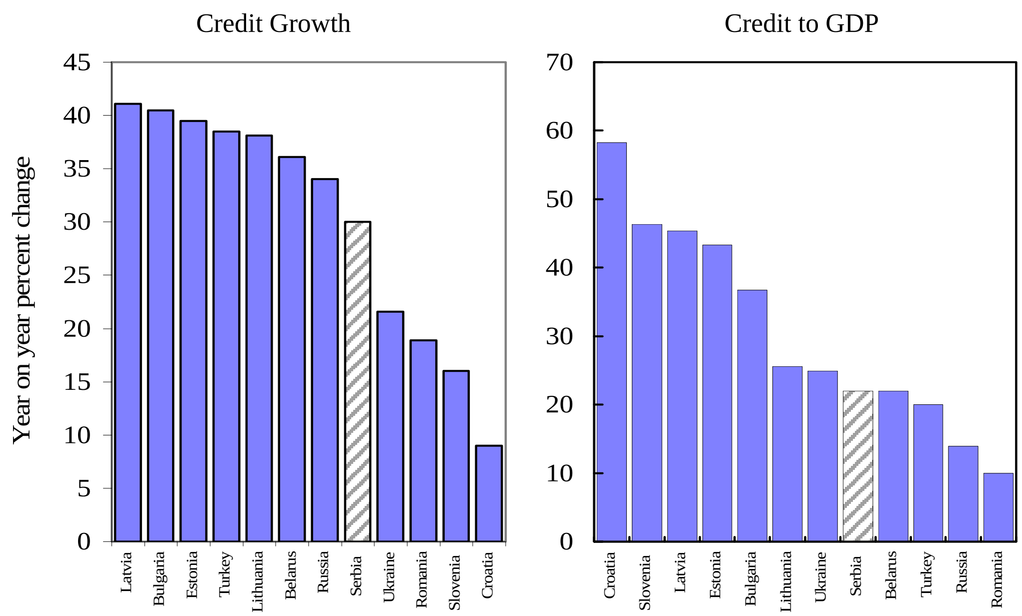
Comparisons of Serbia with other CEE countries suggests that recent rapid credit growth reflects catching up and medium-term financial deepening consistent with structural change and stabilization (Figure 3):

- Serbia has a lower ratio of bank credit to GDP (with GDP in PPP terms) vis-à-vis most other CEE countries.
- Credit expansion has been rapid in comparator countries that have had relatively low initial credit-to-GDP ratios.
- Cottarelli and others (2003)[1/] concluded the steady state credit-to-GDP ratio for comparator Balkan economies is around 41 percent, compared to the current ratio of around 23 percent for Serbia.

However, a continuation of the current growth rate would place Serbia's credit-to-GDP ratio above that consistent with the regional experience within the next few years.

Rapid credit growth continues to be a key policy challenge across the CEE region.[2/] Many countries have adopted a variety of macroprudential measures to stem credit growth with a view to containing macroeconomic vulnerabilities. These measures have had mixed results.

Figure 3. Credit in Selected CEE Countries, 2004



Source: International Financial Statistics (IMF) and country sources.

1/ Cottarelli, C., G. Dell'Ariccia, and I. Vladkova-Hollar, 2003, "Early Birds, Late Risers, and Sleeping Beauties: Bank Credit Growth to the Private Sector in Central and Eastern Europe and the Balkans," *IMF Working Paper* No. WP/03/213 (Washington: International Monetary Fund).

2/ Paul Hilbers, Ceyla Pazarbasioglu, Gudrun Johnsen, and Inci Ötker, 2005, "Assessing and Managing Rapid Credit Growth and the Role of Supervisory and Prudential Policies," IMF Working Paper No. 05/151.

Nonbank financial institutions account for only 10 percent of the financial system

11. **The insurance industry is quite small and underdeveloped**. Traditionally poor governance, inadequate risk management practices and a lack of consumer confidence limited total assets to the equivalent of just below 2 percent of GDP at the end of 2004. The two dominant insurers are socially owned, and fully half of the insurers have been resolved since mid-2004. The private pension industry is quite small and consists mostly of employment-based group arrangements.

12. **Leasing is growing sharply.** The expansion of leasing assets in 2004 to the equivalent of 1.5 percent of GDP from virtually zero was driven by foreign-owned leasing companies that registered in Serbia during 2003–04. Leasing is an important source of funding source for fixed investment and for small and medium-size enterprises.

13. **Finally, capital and money markets are small or nonexistent**. The equity market is very small, there are no domestic corporate bond and paper markets, and there is no secondary market for treasury bills. The largest capital market in Serbia by far is that for euro-denominated bonds issued to compensate holders of frozen foreign exchange deposits. An interbank money market emerged during 2005.

II. Assessment of Systemic Financial Vulnerabilities

14. **There are emerging signs that the rapid pace of bank credit expansion is beginning to erode systemic financial stability.** The transformation of the financial system is providing important benefits to the financial sector and to the economy at large, and, ultimately, should enhance stability. However, the rapid growth of foreign currency-indexed loans of foreign banks striving to gain market share leaves borrowers, and thereby the banks themselves, exposed to an unexpected depreciation of the currency. A lesser risk is posed by the remaining large state-controlled banks in the run up to their privatization owing to their governance and structural weaknesses.

A. Bank Credit Risk

NPLs are high and increasing

15. **The apparent increase in the NPL to total loan ratios of most foreign banks during 2005 could be an early sign of a worsening of financial stability** (Table 3).[2] Although NPL data are not fully reliable, this increase should serve as an early warning. The NPL ratio has also risen for domestic private banks, largely on account of one large and weak bank in this group. The decline in the NPL ratio of the banking system as a whole during the first nine months of 2005 was driven by the write-off of a large amount of bad loans of one state-owned bank.

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[2] Part of this increase is due to the purchase of a large private bank by a foreign bank.

Table 3. Nonperforming Loans and Loan Provisioning
(In percent)

	NPLs to Total Loans			Loan Provisioning 1/		
	2003	2004	Sept-2005	2003	2004	Sept-2005
State-controlled banks	32.1	39.9	32.9	57.5	68.1	66.9
Domestic private banks	17.8	25.2	48.5	39.5	38.3	31.2
Foreign banks	3.9	5.9	10.7	46.5	34.4	36.9
Total	24.1	22.3	19.8	54.0	58.9	47.8

Source: NBS.

1/ Weighted average of provisions for loans in the three worst categories.

Indirect foreign exchange credit risk is high and growing

16. **The indirect foreign exposure of banks leaves them vulnerable to a sudden depreciation**. Most banks do not have a balance sheet mismatch because their financing and lending are both effectively in foreign exchange. However, the dominance of loans either denominated in or linked to the euro to borrowers with income in dinar means that a sudden exchange rate depreciation could threaten their capacity to repay. NBS supervisory data reporting continues to be refined to fully capture the denomination and indexation of loans. Data for September 2005 indicate that the foreign exchange share of the total was 73 percent, compared to 70 percent reported for December 2004.

Stress tests indicate that credit risk is the most significant risk for the system

17. **The mission undertook stress tests based on December 2004 data to assess systemic vulnerabilities, but the results should be interpreted with caution.** Capital for several of the large state banks was adjusted downward to account for additional provisions against Paris and London Club (PLC) loans.[3] Still, the levels of bank capital used in the simulations is overstated to the extent that banks underreport their NPL levels, or make insufficient loan loss provisions for problems identified. In this case, the need for recapitalization resulting from the stress tests may well be underestimated. In addition, the direct effect of an exchange rate shock on borrowers' balance sheets could not be estimated owing to a lack of borrower data. Thus, the impact of a large exchange rate depreciation on banks was gauged indirectly by assuming a given depreciation rate would lead to a given downward migration of loans.

[3] Only one state bank fully provisioned against PLC loan assets. Based on on-site inspections and audit reports it was assumed that 35 percent of the PLC loans had not been properly provisioned against as of December 2004, reducing their capital adequacy ratio by 7 percent.

18. **A credit shock could lead to a material loss of bank capital.** The impact of credit risk was tested by assuming a 25 percent downward migration of loans. This decreased the capital adequacy ratio (CAR) of the system from 27.9 percent to 20.6 percent, three state and one foreign banks fall below 8 percent and three banks fall below 10 percent. The system's nonperforming loans to loans ratio rises by 6.2 percentage points.

Credit risk for the foreign banks could result in a rapid slowdown in credit growth

19. **A credit crunch would seem to be the main problem arising from credit risk.** An assessment of stability must begin with the dominant foreign banks, which provide important benefits to the economy, as well as risks (Box 3). As long as they earn high profits, the foreign banks in Serbia probably have access to new capital from their headquarters given that they account for a small share of the loan book of their international banking group. Their inherent strength and strong reputations make a systemic loss of depositor confidence unlikely. However, a decline in the earnings of foreign banks arising from their fight for market share, coupled with an adverse shock—especially a large depreciation, could lead to a credit crunch with adverse implications for the economy at large.

B. State-Controlled Banks

20. **Several of the systemically important state-controlled banks could pose potential risks ahead of their privatization.** The core problem is that their governance is not market-based; rather, they operate under the influence of the Ministry of Finance (MOF) and the Deposit Insurance Agency (DIA; formerly the Bank Restructuring Agency). Further, the state banks have no ready access to capital, their investments in information technology and credit-risk management lag; and they remain vulnerable to further loss of market share and undue influence while in state hands.

Several large state banks are performing poorly

21. **The performance of the large state banks compares unfavorably with their private sector counterparts.** Based on 2004 results, net profits after tax, return on assets, and return on equity are all negative for the large state banks, but positive and healthy for their competitors. State banks' earnings are well below that of other banks owing to substantial loan loss provisioning and high administrative costs (Table 4). Several of the state-controlled banks are significantly overstaffed and over-branched compared with their rivals.

Box 3. The Benefits and Risks of Foreign Banks in Serbia

Foreign banks are providing important benefits to the Serbian banking sector by:

- Attracting funds from households who may be reluctant to deposit with domestic banks after the foreign exchange deposit freeze and pyramid schemes of the 1990s;
- Providing new sources of funding for domestic credit growth via capital and financing from headquarters;
- Introducing new financial products and credit instruments;
- Reducing the influence of vested interests;
- Enhancing competition by buying state banks and increasing the number of players (bank interest margins are declining in Serbia).

Foreign banks also change the profile of shocks to which the banking system is vulnerable. The foreign banks in principle have easy access to capital because they account for a small share of the assets of their entire group. Still, the following adverse shocks could lead to lower profitability, less willingness on the part of the banking group to provide capital, and, ultimately, generate a credit crunch:

- External shocks
  - A rise in funding costs from higher eurozone interest rates.
  - An adverse shock to one or more of the countries of origin of the foreign banks.
  - Contagion from an adverse shock elsewhere in the CEE region, which could lead to a deterioration of investor perceptions regarding Serbia.
- Domestic shocks
  - Declining margins from foreign banks fighting to gain market share.
  - A flight to quality induced by a weakening economy or an unexpected domestic political event.

Foreign banks could also exacerbate the consequences of an adverse shock by:

- Inadequate risk management in the context of their rapid expansion.
- Increasing euroization and indirect foreign exchange credit risk.

Table 4. Return on Assets and Return on Equity
(In percent)

	Return on Assets		Return on Equity	
	2003	2004	2003	2004
State-controlled banks	-3.2	-6.3	-15.0	-30.0
Privately-owned banks	4.0	4.1	13.4	15.0
Foreign banks	0.9	1.0	6.3	9.4

Source: NBS.

The large state banks are vulnerable to a narrowing of spreads and to credit shocks

22. **Stress tests indicate that a narrowing of margins for the state banks, arising, for example, from greater competition, would further erode their capital.** A small reduction of 2 percent in the spread causes four state banks to become undercapitalized. In addition, stress test results suggest that several of the large state banks are especially vulnerable to credit shocks and possibly to liquidity shocks. A credit-risk shock of a 25 percent migration of NPLs to the next worse classification category would reduce the CAR (adjusted for full provisioning for PLC debt) of one of the large state banks to below 8 percent, and reduce the CAR of another to below 12 percent. In addition, a sudden withdrawal of deposits of local authorities or state-owned enterprises held with the state banks could leave several with an illiquid position.

The state banks could pose vulnerabilities in the run up to their privatization

23. **A shock to the large state-controlled banks would incur fiscal costs and could damage confidence in the banking sector.** The state would likely be obliged to recapitalize a large state-controlled bank in need owing to their limited access to capital markets. Such a recapitalization could slow or even reverse the improvement of confidence in the banking sector. In addition, after experiencing an adverse shock a state-controlled bank would be harder to privatize.

C. Other Potential Vulnerabilities

24. **The mission also analyzed other types of risk, including through stress tests, but they appear to warrant less attention from policymakers, at least in the short run**:

- The banking sector as a whole is *liquid*, with the exception of several of the state banks. However, stress tests suggest that liquidity risks could arise from the concentration of short-term deposits, 55 percent of which was less than one month duration.

- The stress tests indicated that *interest rate* shocks arising from maturity mismatches of assets and liabilities would not pose a significant risk to the system owing to the balance sheet structure of the banks.

- *Leasing* activity of mainly foreign banks, mostly financed by borrowing from affiliated and parent banks, has not yet reached a sufficient magnitude to pose systemic risks, especially because the lessors own the leased asset.

- *Corporate external borrowing* grew sharply in 2004 and 2005 but is unlikely to be a material risk to the financial system as much of the borrowing is by Serbian subsidiaries of multinationals from their parent companies.

III. Policies to Mitigate Financial Vulnerabilities

25. **Serbia is moving toward international best policy practices to mitigate systemic vulnerabilities, after starting from a very low base at the end of the previous regime in 2000.** Further policy measures to enhance bank supervision, the financial infrastructure, and the governance of state-controlled banks to comply with international standards would mitigate systemic financial sector vulnerabilities. In addition, both the financial and macroeconomic vulnerabilities should be mitigated by appropriate fiscal and monetary policies, and, importantly, by reforms in the state-owned enterprise sector.

26. **The recommendations discussed in this section, with a few exceptions, are based on the situation at the time of the March and April 2005 missions** (Appendix II). Implementation of the recommendations is also discussed since most have been implemented.

A. Enhancing the Supervisory Framework

27. **Most of the recommendations on the supervisory framework, and some in other areas as well, follow from the Basel Core Principles assessment of bank supervision (Annex).** The assessment, which was undertaken in April 2005, was decidedly unfavorable. However, since then, the Serbian authorities have taken significant steps to implement many of the recommendations of the assessment, including, in particular, the enactment of a new Law on Banks (LOB) in November 2005. The Second Phase Supervisory Development Plan was adopted in October 2005 together with a time bound corrective action plan to address Basel Core Principle deficiencies identified by the FSAP mission. Other important steps in the transformation to a risk-based approach include the adoption of: (i) a strengthened supervisory operating policy; (ii) a standardized report of examination format; and (iii) a standard Capital Assets Management Earnings and Liquidity (CAMEL) rating system.

More institutional reforms are needed to fully adopt risk-based supervision

28. **The transformation of the NBS Bank Supervision Department (BSD) from compliance-based to risk-based supervision continues.** The next step is to establish clear

standards and risk descriptions against which supervisors are able to judge the adequacy of banks' risk management. In addition, information technology and data systems and training need to be upgraded (Basel Core Principle 16). Further, the NBS should apply remedial measures more actively. Since the FSAP mission, the BSD has enhanced its data-gathering capabilities by requiring banks to report loans by currency denomination.

29. **Closer cooperation with other agencies would improve supervision.** The NBS should improve cooperation with all other domestic agencies, including the MOF (CP 1(6)). Further, the NBS and the home country supervisors of foreign banks should also continue with efforts to agree on memoranda of understanding (MOUs), and fully engage on a two-way basis. To date, MOUs have been signed with five foreign supervisory authorities.

Prudential coverage and regulations are incomplete

30. **The implementation of the legal authority for consolidated supervision should be done in a way that limits banks' use of subsidiaries to circumvent regulatory limits.** Many banks own insurance, leasing and securities companies, but reporting and compliance has not been done on a consolidated basis. Further, there was no separate limit on the aggregate amount in relation to capital of a bank's investments in nonfinancial entities (CP 5, CP 9, and CP 20). However, the NBS in September 2005 brought leasing companies under its supervision. While the new LOB established the principle of consolidated supervision by the NBS, the NBS may not have full general authority to require reporting or obtain information about a banking group or to take any early corrective actions with respect to a banking group. The NBS should in practice ensure that banking groups do not use subsidiaries in a way that enhances systemic risks.

31. **Regulations on exposures to related parties have been partly tightened and any breaches should quickly trigger action by the BSD.** The 5 percent of capital limit on the amount of a bank's exposures to individual related parties is in line with international best practices, but until recently was breached without action on the part of the NBS (CP 10 and CP 22). In addition, there was no limit on the aggregate amount of a bank's exposure to related parties. The new LOB limits aggregate exposure to related parties to 20 percent of capital, in line with the FSAP recommendations. Any breaches of the limits should not be tolerated.

32. **The treatment of NPLs, especially loan loss provisioning rules, are not up to international standards.** Loan loss provisioning rules are based on regulatory prescriptions rather than by loan quality. Further, the current provisions on restructured loans need to be strengthened to link upgrades to a demonstrated track record of repayments. In addition, there have been some 17 ways to use guarantees and/or collateral to reduce loan provisions, creating ambiguity and confusion for both banks and the BSD. The NBS tightened provision requirements in December 2005, and by-laws to the new LOB are expected to rationalize and simplify provisioning rules. In addition, the NBS should improve its methodology for assessing and recording NPLs, including by not adjusting NPL data for collateral.

33. **The strengthening of CARs will make banks less vulnerable to shocks.** The minimum CAR was raised from 8 percent to 10 percent effective March 2005 and to 12 percent effective end-2005. The NBS should also impose capital charges for market risks and against banks' securities held for trading or liquidity purposes (CP 6).

Bank governance is improving

34. **Market discipline of bank management is weak but bank supervisors are gaining more authority over bank governance.** The new LOB reduces the threshold at which a person or entity is deemed to have a significant ownership in a bank from 15 percent to 5 percent (CP 3 and CP 4). Governance will also be improved by the new legal authority of the NBS to vet bank directors in accordance with "fit-and-proper" criteria.

35. **Reforms are under way to shore up bank risk management systems.** Since mid-2005, the NBS has required banks to monitor and assess borrower's exposure to exchange rate risk and to reflect their assessment in the loan classification, but implementation is not complete. The new LOB establishes that the boards of directors of banks are responsible for risk management systems and provides for penalties for misreporting and excessive risk taking (CP 13 and CP 14).

Further prudential measures should be actively considered

36. **As signs of a potential deterioration of financial stability emerge new prudential measures should be considered.** The continued high rate of credit growth and recent increase in foreign bank NPLs requires that further prudential measures be given serious thought. Possible further prudential measures could include tighter loan provision requirements for NPLs, or stricter eligibility requirements for loans. The benefits of these measures for financial stability must be balanced against their adverse impact on bank profitability. In addition, the NBS has implemented a number of macroprudential measures, as discussed below.

B. Modernization of the Financial Infrastructure

The legal framework is in need of modernization

37. **There is general agreement in Serbia that the outmoded and under resourced legal system is not supporting the transformation of the financial system**. Collateral recovery is complex and time-consuming. In addition, the NBS has had difficulty in revoking banking licenses because these decisions are subject to review by both the Commercial Court and the Supreme Court; experience has shown, repeatedly, that these courts have overlapping jurisdictions and their decisions are not necessarily compatible. The new LOB imposes limits on the powers of the courts to review NBS decisions.

38. **Legal protection for NBS staff in their duties supporting financial stability has been strengthened.** Previously, neither the NBS nor its officers and agents had explicit statutory protection against actions for damages when they carry out their duties in good faith

(CP 1(5)), and the NBS and its staff have been repeatedly sued on dubious grounds by banks against whom the NBS has taken supervisory actions. However, the new LOB explicitly sets out the key criteria for revocation of bank licenses and calls for legal protection for NBS staff.

Accounting and auditing practices are poor and capacity is limited

39. **A strengthening of the auditing framework and capacity would help subject bank management to market discipline.** The new LOB should lead to more effective audits by requiring 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. The LOB also allows the NBS to draw up a list of recommended auditors and the NBS can reject audits from auditors not on the list (CP 21). The potentially serious shortage of auditors should be addressed by implementing new licensing procedures.

C. State-Controlled Bank Governance and Privatization

The state banks should be privatized rapidly

40. **Rapid privatization of the remaining large state-controlled banks would limit systemic vulnerabilities.** The DIA already oversees most of the state banks and has proven to be highly efficient in resolving the four large state banks left over from the previous regime. Most state banks have been or are in the process of privatization. Four small and medium state banks were sold in 2005, and a privatization tender for the largest state-owned bank was launched at end-September 2005. However, the privatization strategy for the second large state-controlled bank has not been fleshed out or a timebound plan established. The sale of this bank, preferably to a strategic investor, as soon as possible would reduce financial vulnerability and ensure that this bank contributes fully to economic growth.

41. **Governance of the large state-controlled banks should be strengthened in the pre-privatization interim.** All state bank directors should be subject to NBS "fit and proper" criteria and their reporting requirements strengthened. Their compliance with prudential requirements should be brought fully into line with other banks.

D. Measures to Slow Credit Growth

42. **The authorities have undertaken a series of mostly macroprudential measures aimed slowing credit growth with a view to enhancing macroeconomic stability.** The main macroeconomic vulnerabilities ensuing from the financial sector are the prospect of a sudden cutoff of financing of the wide current account balance, and upward pressure on inflation from high credit growth. Ideally, policy measures to slow credit growth give banks incentives to internalize the adverse macroeconomic implications of their lending decisions. However, in Serbia, as elsewhere, it is difficult to design market-based incentives to stem high credit growth, or even to assess their impact.

The impact of the credit-slowing measures is difficult to quantify

43. **So far, the NBS has:**

- Introduced new guidelines on commercial bank consumer lending (maximum 30 percent monthly payment to net income ratio and a minimum 20 percent down payment to loan ratio) (December 2004).

- Eliminated remuneration on required reserves on enterprises' foreign currency deposits (June 2005).

- Unified SRRs on enterprises and household foreign currency deposits in banks and commercial banks' foreign borrowing at 38 percent.[4] This unification at the level of 38 percent implies some overall tightening compared to the previous SRRs.

- Broadened the reservable base to include commercial banks' foreign borrowing. This measure was effective on January 1, 2005 for all new borrowing, while the entire stock of banks' foreign borrowing was included in three steps during the period September 2005–November 2005.

- Taken over the authority for regulating and supervising the leasing industry (September 2005) and subjected leasing companies to a 10 percent reserve requirement on foreign borrowing (February 2006).

- Obliged banks to make clear in their advertising the denomination of loan payments (December 2005).

44. **Gauging the impact of these measures on credit growth is difficult because they can be expected to have a lagged effect and may be evaded.** Most were implemented after the FSAP missions. However, overall credit growth remained strong during 2005 and accelerated late in the year.

Further macroprudential measures pose very difficult tradeoffs

45. **New and necessarily more intrusive macroprudential measures to slow credit growth should only be used as a last resort.** Possible further macroprudential measures could include marginal SRRs on foreign currency-denominated deposits (as in Croatia), or even controls on capital inflows or credit ceilings (as in Bulgaria). At this juncture, such measures do not seem to be warranted, at least for the purposes of financial stability. The experience of other countries regarding their general effectiveness is mixed; they tend to work only in the short-term, lead to numerous distortions, and can be circumvented.

[4] Previously, the effective SRR on households' foreign currency deposits had been 47 percent, the SRR on enterprise deposits had been 14 percent, and commercial bank foreign borrowing was not subject to SRRs.

Ultimately, these measures could backfire by hurting policy credibility. Thus, they should only be used as a last resort when the discernable costs of credit growth rise to a level that outweighs the costs of administrative measures. Meanwhile, the risks to financial stability posed by rapid credit growth should be met by establishing by-laws and the regulatory changes called for under the new banking law and fully adopting risk-based supervision and improving supervisory capacity. The need to resort to further macroprudential measures would be mitigated by implementation of the appropriate fiscal, monetary and structural policies.

IV. Monetary and Systemic Liquidity Framework

46. **Financial sector deepening will enhance the role of monetary policy in mitigating financial vulnerabilities.** Currently, monetary policy aims at bringing down inflation in the context of an orderly exchange rate depreciation and an adequate reserve cushion. Monetary policy implementation has been hampered by a lack of suitable instruments, which has led to a reliance on changes in SRRs.[5] In addition, policy interest rates were low or negative in real terms during the first 10 months of 2005 (Figure 4). Against this background, euroization has steadily increased (Box 4). Looking ahead, a shift in the emphasis of monetary policy from the exchange rate to an inflation target would better support financial and macroeconomic stability and help stem euroization. This shift will require developing expertise at the NBS to implement a more forward-looking and market-based monetary framework in which more exchange rate variability is likely and repos are a more active policy instrument.

The NBS is moving to a market-oriented and open monetary framework

47. **The shift from SRRs to a single market-based main monetary instrument within an interest rate corridor is nearly complete.** In January 2005, the NBS introduced weekly repo auctions collateralized by government bonds held by the NBS at various maturities. During the second half of 2005, 10 banks established a "Belibor" market with a yield curve up to six months, which should greatly facilitate market-based monetary operations. Dropping the requirement that each and every day the banks maintain with the NBS at least 80 percent of the SRR would help the money market develop, and the NBS has committed to lowering this minimum to 50 percent during 2006. Use of a single repo maturity as the main policy interest rate would provide a simple and transparent policy signal for the markets and the public; the NBS is now indicated that it will use the 14 day repo rate for signaling purposes. A new unified standing lending facility with automatic link of interest rates to the repo rates has been introduced, and the deposit facility interest rate was increased, although it still differs substantially from the repo rate. In choosing the floor and ceiling of the interest

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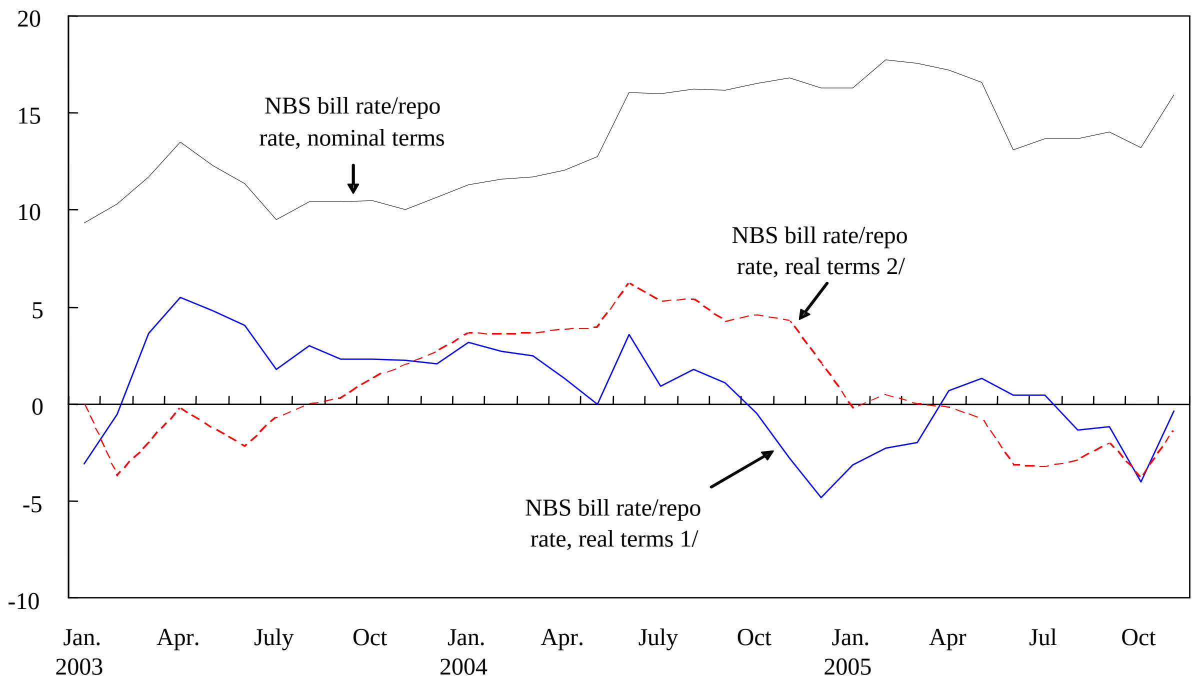
[5] SRRs have been adjusted frequently in recent years. As of December 2005, the SRRs for reservable dinar and foreign exchange liabilities were 18 percent and 38 percent, respectively; the differential is intended to reduce euroization. Reserves are not remunerated, and reserves against foreign exchange liabilities are denominated in foreign currency.

rate corridor, a balance will need to be struck between a width narrow enough to contain interest rate volatility, yet wide enough to allow the money market to develop.

Figure 4. Policy Interest Rates



Source: NBS.

1/ NBS bill rate through January 31, 2005, when the NBS replaced the issuance of NBS bills with weekly repo operations; calculated on rolling 12-month average RPI (backward).

2/ NBS bill rate through January 31, 2005, when the NBS replaced the issuance of NBS bills with weekly repo operations; calculated based on rolling 6-month average RPI (3 months backward/3months forward).

48. **More extensive policy analysis and public reporting of monetary conditions and policies by the NBS would enhance the effectiveness of monetary instruments**. Further analytical work by the NBS on monetary transmission and pass-through would enhance the operation and transparency of monetary policy.

Monetary transparency is improving

49. **The MFP Transparency Assessment (Annex) concluded that policy effectiveness would gain from greater public disclosure of the broad objectives and intermediate targets.** Public information services of the NBS rely on a variety of media, with published material, electronic updates and verbal communication. The availability of information is, however, undermined by poor consistency with statistical standards. Serbia subscribes to neither Special nor General Data Dissemination Standards, definitions of balance of payment concepts are only partly in line with the 1993 IMF Balance of Payments Manual, and Serbia is not included in *International Financial Statistics*.

Box 4. Euroization in Serbia 1/

The level of financial euroization in Serbia is high by international standards. More than two-thirds of total deposits are denominated in euro, and almost three-fourths of banks loans are either denominated in euro or indexed to the euro. The prices of "big ticket" items and many others are de facto indexed to the dinar/euro exchange rate and payments are often made in euros. Besides Serbia's history of monetary instability, euroization reflects negative real interest rates on dinar deposits, the comparative stability of the exchange rate regime, which has induced a sense of one-way risk in the foreign exchange market, and the entry of foreign banks interested in doing business only in euro.

The costs of euroization appear to outweigh the benefits. Euroization has brought the benefit of enhanced reintermediation owing to the greater confidence in the euro vis-à-vis the dinar in the wake of the political turmoil of the 1990s and the depositing of savings which hitherto had been kept as "mattress money." However, as Serbia is some way from possible EU accession and adoption of the euro, there are also costs from the high euro usage, especially indirect foreign exchange credit risk. Euroization also constrains monetary policy effectiveness and limits exchange rate policy options by increasing potential exposure to exchange rate shocks.

Thus, policies should aim to contain and eventually reverse euroization. The international experience has shown that enhancing the credibility of the policy framework and lowering inflation are vital to reversing euroization. In Serbia, this would involve: completing the move to market-based monetary policy instruments, a firm monetary policy stance to ensure appropriate levels of positive real interest rates, removing a sense of one way risk in the foreign exchange market, developing appropriate hedging instruments, restructuring the state sector, and continuing with financial reforms.

1/ See Saker, Neil, and Andreas Westphal, 2005, "Euroization in Serbia: Macroeconomic, Prudential, and Policy Implications," in *IMF Country Report No. 05/232*, July.

The payment system is excellent

50. **The real-time gross-settlement (RTGS) system is highly reliable and fully compliant with the Core Principles for Systemically Important Payment Systems (Annex).** The old central command-oriented payment system was thoroughly transformed in January 2003. Large-value and time-sensitive payments are now settled in a new RTGS system, and retail payments are processed in the NBS clearing system. Payments are settled smoothly, as banks can use in full intraday their required and free reserves held with NBS. Business and operational features offered by the system meet the needs of participants and the economy in general. Technical availability has been very good and a remote disaster stand-by site facilitates business continuity management. The system would benefit from being subject to regular risk analysis, and securities clearing and settlement issues will warrant more attention as financial markets develop.

Lender of last resort facilities have been much improved

51. **Lender of last resort arrangements have been reformed to address moral hazard concerns**. Previously, the arrangements were complex and ad hoc. However, the NBS has recently introduced a new unified standing lending facility with automatic linkage of interest rates to the repo rate. Requiring a penalty rate for repeated use and subjecting banks that repeatedly access the facility to resolution in accordance with the LOB would bring it fully in line with international best practices.

Implementation of the new deposit insurance scheme may require enhanced capacity

52. **A new deposit insurance scheme (DIS) has been introduced**. The new DIS, which is administered by the DIA, provides €3,000 coverage for household deposits only, targeting an estimated 98 percent of household depositors and 23 percent of household deposits. Moral hazard concerns are limited because the scheme is explicitly designed for small depositors and the new law prohibits liquidity support to distressed banks. The collection of the premium will be suspended when the scheme reaches 5 percent of total deposits.

V. FINANCIAL DEVELOPMENT

53. **The uneven nature of development of the financial system in Serbia has increased financial vulnerabilities and left much scope for broadening financial services.** The banking sector is growing but nonbank financial markets are either small or nonexistent. Reforms to broaden and deepen the financial sector would reduce its vulnerability by increasing the number of credit suppliers. In addition, a more developed financial sector would provide more financial services and better support sustainable economic growth.

The small insurance sector needs to be rationalized and developed

54. **The insurance industry is small, marked by restrictive trade practices, and dominated by two large socially owned insurers.** Key restrictive trade practices are the

requirements that reinsurance must be placed with domestic reinsurers to the extent possible, and that nonlife contracts (relating to Third Party Liability insurance for state owned firms) must be of a 10-year duration. The two dominant and poorly performing large socially owned insurers account for around two-thirds of reported premium income and the bulk of their reported assets are receivables and fixed assets.

55. **The Insurance Law of May 2004 transferred insurance supervision to a new Insurance Supervision Department (ISD) in the NBS**. Previously, insurance supervision was done by the since-abolished federal government, which had very limited capacity. The new department is implementing an ambitious work program, including the closure of 16 insurers between November 2004 and October 2005 (the DIA handles liquidation and bankruptcy). Recruitment and training of new staff is under way. However, capacity is limited especially with regard to actuarial and off-site inspection skills.

56. **The key reforms to build the insurance sector are resolution, privatization, and completion of the new regulatory framework.** The two large state insurers should be subject to a special on-site supervisory examination, and required to submit business plans and appoint financial advisors to develop and execute a privatization strategy. Clarity of insurer balance sheets would be made possible by ensuring that IFRS and NBS accounting rules are fully applied to fixed assets and accounts receivable. Finally, the phasing out of restrictive trade practices would level the playing field for new entrants.

Development of capital markets must start virtually from scratch

57. **The early stage of capital market development means that policy must focus on enhancing infrastructure and governance.** The lack of nonbank sources of financing precludes the corporate sector from being able to hedge against foreign exchange risk and exacerbates the vulnerability of the economy to corporate sector stress. The Securities Commission (SC) is disadvantaged by insufficient legal authority, weak institutional capacity, and limited regulatory instruments. The transparency of the ownership and control of traded companies should be enhanced including by requiring the disclosure of large shareholder owners. Shareholder protection during capital increase and takeovers should be enhanced by greater transparency and regulatory framework with stronger enforcement powers. Strengthening the SC's legal authority and institutional capacity would enhance confidence. A new regulatory framework for investment funds in line with EU Directives and international practice would do much to foster market development.

VI. Anti–Money Laundering and Combating the Financing of Terrorism

58. **A MONEYVAL report was adopted in January 2005.** The report indicated that the Administration for the Prevention of Money Laundering (APML) is proactive and has a dedicated staff. Customer identification and integrity standards, internal control rules, and enforcement powers and sanctions are generally adequate. The APML chairs an interagency working group to implement the MONEYVAL recommendations, and cooperation with other domestic agencies is also working reasonably well. The APML will soon move to larger premises and its staff doubled to around 35 persons, and it is expected to soon have its

own dedicated budget. The agency will be seeking donor funding to upgrade its software to analyze faster and more efficiently the substantial number of transactions that are reported each day. A new AML Law is currently being drafted.

59. **Training of staff of other agencies involved in the AML/CFT effort is well under way.** The APML has signed an MOU with the NBS that allows the NBS to share information gathered from its on- and off-site supervision with the APML having responsibility to pass on any issues to the Prosecutor's Office.

60. **The MONEYVAL report notes that while it is possible to confiscate the proceeds of crime, it is not possible to confiscate or seize money intended to finance an act of terrorism.** These omissions have been corrected by recent amendments to the Criminal Code and the AML Law that criminalize terrorist financing. Changes allowing confiscation without conviction is currently being discussed by the interagency working group.

OBSERVANCE OF FINANCIAL SECTOR STANDARDS AND CODES—SUMMARY ASSESSMENTS

The annex contains summary assessments of international standards and codes relevant for the financial sector. The assessments have helped to identify the extent to which the supervisory and regulatory framework is adequate to address the potential risks in the financial system.

The following detailed assessments of financial sector standards were undertaken:

- The *Basel Core Principles for Effective Banking Supervision* (BCP) by Ronald MacDonald (expert) and Walter Zunic (expert);
- The Fund's *Code of Good Practices on Transparency in Monetary and Financial Policies* by Marie Thérèse Camilleri; and
- The Committee on Payment and Settlement Systems *Core Principles for Systemically Important Payment Systems* (CPSIPS) by Tom Kokkola (European Central Bank).

The assessments were carried out during a mission to Belgrade April 12–26, 2005 and were based on the laws, regulations, policies and practices in place at the time the assessments were made.

The sources for the assessments included:

- Self-assessments by the supervisory authorities;
- Reviews of relevant legislation, decrees, regulations, policy statements and other documentation;
- Detailed interviews with the supervisory authorities;
- Meetings with other authorities and independent bodies; and
- Meetings with the financial sector firms and associations.

BASEL CORE PRINCIPLES FOR EFFECTIVE BANKING SUPERVISION

Institutional setting and market structure—overview

61. **During recent years there have been substantial changes in the banking sector.** The formerly dominant state-controlled banks are now being privatized, while the private domestic banks are showing little growth. By contrast, foreign banks have been expanding very rapidly and now account for most of total banking assets.

62. **The NBS is the sole supervisory authority for banks operating in Serbia.** It is empowered to grant and revoke banking licenses, to take enforcement measures against banks and to issue detailed Decisions (effectively regulations) which implement certain prudential provisions in the LOB and the NBS Law.

General preconditions for effective banking supervision

63. **The NBS is both the monetary and supervisory authority.** It has adequate powers and resources to review and influence the operation of the aggregate banking system. In addition, it functions as the supervisor of individual banks and (since 2004) of insurance companies. Individual banks' activities are overseen through a combination of off-site monitoring and on-site examination. By law, the NBS has full autonomy in carrying out its supervisory responsibilities. In practice, however, this autonomy is impaired to some extent

in relation to the state-controlled banks, most of which come under the aegis of the DIA and are potentially exposed to governmental interference in their operations. There is no evidence of governmental interference in the supervision of other banks. The NBS generates its own income from its central banking operations. This provides adequate resources to fund its supervisory functions without any need for support from the state budget.

Main findings

64. **Objectives, autonomy, powers and resources (CP 1): The NBS is the sole authority with responsibility for licensing, supervising and closing banks.** It has a generally satisfactory range of regulatory and enforcement powers for performing this task, the most conspicuous weakness being an absence of powers to supervise banks on a consolidated basis. While the NBS also enjoys legal autonomy in supervising banks, there is evidence that this has been compromised in practice through governmental interference in the supervision of state-controlled banks. Moreover, the effectiveness of the NBS as a supervisory authority is impaired by the lack of specific legal protection for the NBS and its officials when taking supervisory measures in good faith in accordance with the law. Supervisory decisions can also be easily challenged in the ordinary courts although these are not yet well equipped to resolve such issues. While the NBS has adequate powers to safeguard the confidentiality of information and to disclose such information to other domestic and foreign supervisors, it needs to put in place clear procedures for exchanging confidential information and, when necessary, coordinating supervisory measures. Although the number of NBS supervisors and their financing are adequate, practical experience is limited and the NBS should concentrate on developing greater depth of supervisory expertise.

65. **Licensing and Structure (CPs 2-5): The detailed provisions governing the licensing of banks and the range of their permitted activities are generally clear and robust.** However, the procedures for ensuring that members of a bank's board of directors and supervisory board are "fit and proper" are inadequate and should be strengthened. The ability of the NBS to control the entry of new investors into existing banks also needs to be enhanced: at present prior approval by the NBS is required only in cases where the new investor acquires 15 percent or more of voting rights. This threshold should be reduced to 5 percent or lower in cases where it is known that a new investor is likely to exercise significant influence. The provisions governing banks' ability to invest in other entities are unsatisfactory in that banks do not require prior approval to acquire control of a nonfinancial entity provided the value of the acquisition is less than 15 percent of the investing bank's capital. This threshold should be reduced. In addition, the rules should be amended to facilitate appropriate investments by banks in other financial entities, subject to prior NBS approval, and the introduction of consolidated supervision of banking groups.

66. **Prudential Regulations and Requirements (CPs 6-15): NBS regulations on capital adequacy and large exposures are generally adequate for limiting banks' credit and concentration risks.** However, these need to be applied additionally on a consolidated basis in order to be fully effective, while capital charges for price risk on banks' holdings of

securities are also needed. Moreover, concentration risk is exacerbated in practice by a degree of forbearance toward certain state-controlled banks. In addition, the current limits on banks' connected exposures are quite liberal and should be tightened, including the introduction of an aggregate limit on such exposures. When consolidated supervision is introduced, the NBS should also be empowered to apply, subject to appropriate conditions, more liberal limits to banks' exposures to related financial entities in cases where banking groups need such treatment in order to operate efficiently as single business entities.

67. **While the NBS has issued reasonably effective guidelines for banks' credit policies and practices, it needs to tighten its procedures for evaluating the quality of banks' assets and the adequacy of their loan loss provisions.** In particular, it should consider how its guidelines might adequately capture the significant indirect credit risk inherent in banks' currency-indexed loans to residents.

68. **The NBS has issued useful guidance to banks on how they should organize their internal controls.** However, the impact of this guidance is undermined by the current absence of any legal requirement for banks' boards of directors to ensure that their institutions have in place adequate systems of risk management or internal controls. Risk management and controls in banks need to be strengthened. To achieve this, the new banking law should set clear standards against which the NBS can judge the adequacy of individual banks' systems, and empower the NBS to hold banks' boards of directors directly responsible for implementing corrective measures which it considers that their banks need to take in order to operate safely.

69. **Methods of Ongoing Supervision (CPs 16-20): during recent years the NBS has significantly improved the intensity and methods of its supervision.** In particular, risk-based methods and an early warning system have been adopted. The establishment of an internal Supervision Review Committee will also promote a more consistent approach toward banks in difficulties. At the same time, most supervisory personnel still lack extensive practical experience, while a particular concern is the shortage of IT specialists who can assess the reliability of banks' systems in generating the financial data they report to the NBS. Recruitment and training of supervisors should be given high priority. As noted above, the absence of consolidated supervision undermines the adequacy of several of the supervisory methods.

70. **Information Requirements (CP 21): The relatively new Accounting and Auditing Law (applicable to 2003 and subsequent reporting years) requires banks to prepare published financial statements in accordance with IFRS.** However, this is contradicted by a separate NBS requirement for banks to prepare their financial statements in accordance with a uniform chart of accounts. Consequently, the banks' published financial statements do not comply fully with IFRS (for example, consolidated statements are not required). The NBS should amend its accounting requirements for banks, so that the banks are able to produce all the information the NBS needs for supervisory purposes, but are no longer prevented from producing published financial statements which comply fully with IFRS. The

NBS should ensure that, as far as practicable, banks use the same accounting policies for both types of reporting.

71. **Formal Powers of Supervisors (CP 22): The NBS has adequate legal powers to take measures against banks that have infringed prudential regulations or whose financial condition is weak, and to tailor its measures according to the gravity of a specific situation.** The NBS also has a successful record of closing banks and applying remedial measures in serious cases where it has a clear and unambiguous legal basis for acting. However, there are other instances where it has shown forbearance, particularly breaches of prudential lending limits by state-controlled banks. The NBS should adopt a fully consistent approach in the exercise of its enforcement powers.

72. **Cross-border Banking (CPs 23-25): At present Serbian banks have no foreign establishments.** Several foreign banks have opened establishments in Serbia and the NBS supervises these establishments in the same way as domestic banks. When licensing new foreign banks, the NBS should strengthen its procedures for assessing of the quality of the consolidated supervision practiced by home country supervisors and establishing co-operation with them.

Table 1. Serbia: Recommended Action Plan to Improve Compliance with the Basel Core Principles

Reference Principle	Recommended Action
CP 1	Implementation of the proposed new banking law and issuance of implementing decisions/regulations. Remedial actions taken by the NBS on basis of new laws to reflect enforcement of new provisions, with focus on board and management responsibility in meeting compliance and in running their institutions in a safe and sound manner.
CP 1.5	The new banking law should give the NBS, its Governor, and its staff legal protection against lawsuits resulting from measures taken in good faith in the course of carrying out banking supervision duties in accordance with that law.
CP 1.6	The NBS should take the necessary steps to ensure a formal system for exchange of information and co-operation with domestic agencies that have responsibility for the soundness of the financial system, and with foreign agencies that have supervisory responsibilities for the owners of the banks/subsidiaries/branches of the Serbian banking system.
CP 2	The NBS should strengthen its system for evaluating the suitability of members of boards of directors and supervisory boards in accordance with the fit and proper criterion.
CP 4	The new banking law should reduce from 15 percent to 5 percent (or lower) the threshold at which a person must obtain the prior approval of the NBS before acquiring an initial shareholding in a bank.
CP 6 (and CP12)	The NBS should impose capital charges for market risk against banks' securities held for trading or liquidity purposes
CP 8	The Decision on the Criteria for Classification of Assets should be simplified. Also, borrowers whose earnings are not in foreign currency and who will suffer a deterioration of their financial position due to the

	impact of a steady depreciation of the SRD should be classified in the B category which requires a 5 percent reserve allocation.
CP 9	The BSD should include in its supervision a review of banks' sectoral or geographic exposures.
CP 10	The new banking law should impose a limit (e.g., 20 percent of capital) on banks' aggregate exposure to connected parties. However, it should also give the NBS discretion to exclude from the aggregate limit, exposures to connected banks and financial companies (e.g., leasing companies) provided that the bank is subject to consolidated supervision.
CP 11	The NBS should review banks' policies for managing country and transfer risk in their claims on banks in foreign countries
CP 13	The NBS should issue new and more detailed standards for banks' risk management. The new banking law should make banks' boards of directors responsible for the adequacy of their banks' risk management.
CP 14	The NBS should issue a Decision requiring that responsibility is assigned to the management and the supervisory boards, and to management, for the accurate and truthful presentation of financial statements to the public and the regulators. The bank supervisors should also be provided with: a) authority to direct re-filing and publishing of amended financial statements; and b) the authority to sanction the bank and individuals for meaningful amounts, in case of above.
CP 15	Prompt implementation by Serbia of the actions detailed in the Recommended Action Plan to improve compliance with FATF, as recommended by MONEYVAL. The NBS should ensure that the holders of numbered accounts at banks can be properly identified by bank management and should ensure that this type of accounts is not posing a money laundering risk.
CP 16	As a minimum, two data systems specialists should be assigned on a permanent basis to the BSD. The BSD is weak in the areas of risk assessment of financial institutions. Additional focused training of supervisors is required. The scope of NBS on-site inspections should include a thorough review of the accuracy of financial reports submitted by the bank. The scope and decision-making of the Supervisory Review Committee should be reviewed.
CP 18	The NBS should commence collecting information on a consolidated basis.
CP 20	The new law should provide the NBS with sufficient powers to supervise banks on a consolidated basis, possibly in line with the minimum requirements in the relevant EU directives.
CP 21	The NBS should introduce a new chart of accounts for banks which directly supports the preparation of both published financial statements and supervisory reports in accordance with IFRS accounting principles. The NBS should issue a Decision requiring that responsibility is assigned to the management and the supervisory boards, and to management, for the accurate and truthful presentation of financial statements to the public and the regulators. Also, the bank supervisors should be provided with authority: (a) to direct re-filing and publishing of amended financial statements, and (b) in such cases to sanction the bank and individuals for meaningful amounts.
CP 22	The NBS should apply remedial measures more actively, particularly in cases of serious or protracted breaches of regulations. The new law should also hold members of banks' boards of directors and

	supervisory boards personally responsible for noncompliance.
CP 25	The new banking law should develop more specific provisions for the licensing and supervision of foreign banks' establishments. The NBS should continue its efforts to enter into MOUs with the home country supervisors of all foreign banks.

Authorities' Response

73. **A draft of this assessment was discussed in detail with the NBS during the FSAP mission in April 2005.** The NBS recognized that supervision has some shortcomings but did not agree with all of the assessments. They also stressed that a number of actions are being undertaken to improve supervision. No written responses were received.

TRANSPARENCY OF MONETARY POLICY

General

74. **The price stability objective is clearly specified in legislation, but there is room for improvement in the public disclosure of linkages with exchange rate policy and the relative importance of financial stability.** The process for formulating and reporting policy decisions is open, with a presumption toward communication and consultation. Public information services of the NBS rely on a variety of media, with published material, electronic updates and verbal communication. Public availability of information is somewhat limited by poor consistency with statistical standards and a lack of data on emergency liquidity assistance.

75. **While the institutional framework establishes the modalities for monetary-fiscal coordination, operational demarcations are somewhat unclear.** The means, methods, and procedures used by the NBS to account for its actions and report on its activities combine *ex post* and *ex ante* accountability. Although the legal basis for NBS instruments is clear, the extent to which it may effectively use them to attain its policy objectives is crucial for accountability. Timely, comprehensive and audited financial reports are only provided on an annual basis. Although NBS advances to the government, profit allocation and the maintenance of capital are publicly disclosed, recapitalization procedures should be further clarified. The internal audit function provides an assurance of integrity in NBS operations, although the lines of reporting may be subject to review. There are high standards of conduct for officials and staff with strong safeguards against conflict of interest, but no legal protections for officials and staff in the conduct of their duties.

Main findings

Clarity of NBS roles, responsibilities and objectives in monetary policy

76. **The price stability objective is clearly specified in legislation, but there is room for improvement in the public disclosure of linkages with exchange rate policy and the relative importance of financial stability.** Within the parameters of price stability, the

statutory extent to which the NBS must support the economic policy of the government is more clearly defined than the relative importance of financial stability. The effectiveness of monetary policy may be undermined by limited public awareness and understanding of monetary policy and macro-financial linkages, suggesting an emphasis on explanation as well as disclosure. Broad policy objectives and intermediate targets (within which the reliance on the exchange rate as a nominal anchor) may be further explained. The considerations underlying monetary policy decisions are promptly disclosed through the publications and complemented by proactive NBS public information services. More research and publicly disclosed reports by the NBS on monetary policy transmission and pass-through variables would improve public understanding of the impact of the monetary stance on price stability, thereby improving policy effectiveness.

77. **While the institutional framework establishes the modalities for monetary-fiscal coordination, operational demarcations are unclear.** The legal framework establishes clear modalities for monetary-fiscal coordination. The Governor attends government meetings of relevance to the NBS, the MOF consults the NBS on draft of laws and the budget, and, at the motion of the NBS, the government may propose to the National Assembly the adoption of laws related to the objectives and tasks of the central bank. However, operational demarcations and agency roles warrant further clarification.

Open process for formulating and reporting monetary policy decisions

78. **The process for formulating and reporting policy decisions is open, with a presumption toward communication and consultation.** The recent implementation of advance meeting schedules for Monetary Board meetings and the automatic disclosure of the decisions taken therein are expected to significantly improve transparency. The NBS Governor also engages in active communication on policy settings with financial markets and the public at large through the local media. The NBS engages in public consultation through its web-site, by posting draft measures or regulatory texts, together with a timeframe for their implementation. Questions and comments are received from the banks and the public at large and round tables and seminars are organized when relevant, as in the preparation of the draft Law on Deposit Insurance. The public relation function of the NBS is considering the establishment of a call center to facilitate two-way communication.

Public availability of information on monetary policy

79. **The public information services of the NBS rely on a variety of media, with published material, electronic updates and verbal communication.** Press conferences are held at least once a month, supplemented by briefings for journalists and public consultations on current topics. The Governor and the members of the Monetary Board make frequent statements to the media and the public at large regarding current issues. Texts of regulations are readily available to the public. The NBS web-site contains links to laws, regulations, instructions and circulars. Reporting guidelines establish the content of reports on operation that must be submitted by banks and other financial organizations to the NBS.

80. **The public availability of information is somewhat limited by a lack of consistency with statistical standards and a shortfall of data on emergency liquidity assistance.** Serbia does not subscribe to the Special, General, and Data Dissemination Standards. Definitions of balance of payments concepts are only partly in line with the 1993 IMF Balance of Payments Manual and there is no consistency with IMF data dissemination standards. Serbia has no IFS pages. Emergency liquidity assistance for banks may be provided but no such information is disclosed. It is not clear whether or not the NBS has engaged in emergency liquidity assistance for banks, and if it has, no information on aggregate amounts is publicly disclosed.

Accountability and assurances of integrity by the NBS

81. **The means, methods, and procedures used by the NBS to account for its actions and report on its activities combine *ex post* and *ex ante* accountability.** The Council (to which the Governor reports on the conduct of monetary policy) reports to the National Assembly on all the factors affecting the implementation of monetary policy, as well as on the state of the banking sector and the overall financial system. It also communicates, for information, the monetary policy program for the following year. The law sets out clear modalities for financial reporting. In reporting to Parliament for the 2003 financial year, the Governor took questions from the floor regarding the financial statements of the NBS. NBS officials may also be called upon by the National Assembly to explain their policies or performance, and exchange views on relevant issues. However, reporting requirements tend to be met by the submission of the relevant documents, rather than by their discussion in front of the designated public authority.

82. **Although the legal basis for NBS instruments is clear, the extent to which it may effectively use them to attain its policy objectives is questionable.** There appear to be some limitations in the NBS authority with regard to bank supervision. It is expected that matters such as NBS approval or rejection of banks' board members and the possibility for legal action against bank auditors if a clean bill of health is given in spite of evidence to the contrary will be addressed in forthcoming proposals for amending the LOB, in line with similar provisions in the insurance law.

83. **Timely, comprehensive and audited financial reports are provided on an annual basis only.** The Annual Report contains audited financial statements of NBS operations, as well as the income statement (with information on the expenses incurred and the revenues obtained in operating the central bank). The financial statements are audited by an independent external auditor. The selection of the latter is based on public tender with strict rotation procedures. The annual financial statements include information on accounting policies and qualifications, but no summary balance sheets are provided on a monthly or quarterly basis.

84. **Although NBS advances to the government, profit allocation and the maintenance of capital are publicly disclosed, recapitalization procedures should be further clarified.** NBS profits are primarily allocated to replenish minimum capital, with

additional appropriations of up to 30 percent transferred to special reserves and the remainder, reduced by the amount of unrealized gains, allocated to the government. If losses are not covered by special reserves, budgetary transfers or government debt securities would cover the shortfall. NBS advances for financing temporary illiquidity of the budget must be within the framework of the monetary policy program, up to 5 percent of the average revenue of the last three years. No mention is made of the repayment period and applicable interest rate however. In addition, the transformation of outstanding government debt into government securities, the considerations underlying its pricing and liquidity, and the impact of valuation on the capital position of the NBS all remain unclear.

85. **The internal audit function provides an assurance of integrity in NBS operations, although the lines of reporting may be subject to review.** There is no disclosure of the Annual Audit Plan; the audit charter and supporting manual are also treated as internal documents. Internal auditors are subject to a cooling off period of one year for internal candidates, in that the persons selected may not conduct an audit of the department in which they were previously employed. The lines of reporting are essentially to the Governor (entrusted with appointing the Internal Auditor), with some parallel reporting to the Council, even though the Council is responsible for the oversight of NBS operations and is the body which provides an element of checks and balances on the function of the Governor. The NBS reports that it is currently considering the creation of an Audit Committee. It remains to be seen whether such a body would significantly alter the governance structure and provide further assurances of integrity in the conduct of NBS operations.

86. **There are high standards of conduct for officials and staff with strong safeguards against conflict of interest, but no legal protections for officials and staff in the conduct of their duties.** Fiduciary obligations are fulfilled and internal regulations cover sound work practices, staff rights and obligations. There is no information on legal protections to assure the public that NBS officials and staff perform their duties without fear of being personally subjected to legal action. Indeed, the threat of legal action affects policymaking in controversial areas and could significantly undermine NBS effectiveness, particularly in bank and insurance supervision.

Authorities' Response

87. **A draft of this assessment was discussed in detail with the NBS during the FSAP mission in April 2005.** They noted the ongoing improvements in disclosure practices. No written response was received.

Table 2. Recommended Plan of Actions to Improve Observance of the IMF MFP Transparency Code Practices—Monetary Policy

Reference Practice	Recommended Action
I. Clarity of Roles, Responsibilities and Objectives of Central Banks for Monetary Policy	
Practice 1.2.2	Disclose (in addition to aggregate data within annual NBS balance sheet and monthly monetary surveys of NBS statistical bulletin) information on the volume, interest rate and maturity of outstanding advances, and the structure, volume, interest rate and duration of government deposits.
II. Open Process for Formulating and Reporting Monetary Policy Decisions	
Practice 2.2.1	The Press Service has started to publicly disclose the advance meeting schedule for the Monetary Board meetings. At the conclusion of every schedule meeting the Press Service states that it will inform the public on main decisions taken therein through press releases.
III. Public Availability of Information on Monetary Policy	
Practice 3.1	Initiate statistical work to ensure consistency with IMF data dissemination standards and to provide IFS pages for Serbia.
Practice 3.2	Provide information on NBS aggregate market transactions.
Practice 3.2.1	Provide summary NBS balance sheets and publicly disclose the latter on a frequent and pre-announced schedule.
Practice 3.2.2	Disclose aggregate amounts and terms of NBS refinance facilities, in addition to a description of monetary operations.
Practice 3.2.4	(see 3.1 above) Work toward the subscription to IMF General or Special Data Dissemination Standards.
IV. Accountability and Assurances of Integrity by the Central Bank	
Practice 4.4.1	Provide information on legal protections for NBS officials and staff in the conduct of their duty.

Core Principles for Systemically Important Payment Systems

Institutional and market structure

88. **The start of operation in January 2003 of the NBS RTGS and Clearing Systems constituted a key milestone in the restructuring of the Serbian payment infrastructure.** All dinar interbank payments in Serbia had been controlled by a state-controlled decentralized and highly opaque entity with branches throughout the country and a staff of some 7,000 people. The leadership and guidance provided by the NBS greatly contributed to the success of the restructuring project.

89. **The settlement of all interbank transfers of funds in Serbian dinar is effected through centralized payment systems owned and operated by the NBS.** This assessment covers the main payments system is Serbia: the NBS RTGS system. In 2004, about 90 percent of all interbank payments, in value terms, were settled in the NBS RTGS system. However, in terms of volume, only some 5.5 percent of the total traffic was settled through the RTGS system.

90. **The NBS offers two logically independent dinar systems operated on a common information systems platform.** The NBS RTGS system that provides facilities for the real-time gross settlement in central bank money of credit transfers in Serbian dinar is also used for the processing of time-sensitive payments of any size. There are 46 participants, comprising: 42 banks, the NBS, the Serbian Bankers' Association's Cheque Clearing System, the Central Securities Depository and Clearing House of Serbia and the MOF. Payment flows in the NBS RTGS system show a fairly low degree of concentration. Taken together, the four biggest banks generate only some 30 percent of both value and volume processed. The other NBS clearing system provides for net settlement of large volumes of low-value interbank transactions. It handles both credit and debit transactions. Net balances arising in the clearing system are settled in the NBS RTGS system.

91. **Banks can use their required and free reserves held with the NBS in full for intraday settlements.** Where necessary, RTGS participants can obtain intraday credit free of interest charge from the NBS against eligible collateral, at present; however, participants only make limited use of this facility. Due to the ample availability of liquidity and banks' use of their internal schedulers, the central queuing system is de facto used very rarely. The RTGS system offers the possibility to "block" funds in view of being used for certain specific purposes.

92. **Within the NBS, the General Manager of the Payment Systems Department has the opportunity to provide information and discuss payment systems issues in bi-weekly meetings of NBS Senior Management.** Within the banking community, the Serbian Banker's Association (SBA) provides a forum for co-operation between banks. At the SBA, payments issues are handled by the Payment System and the Legal Committee.

General preconditions for effective payment systems

93. **The mission finds that the NBS RTGS system observes all applicable Core Principles.** The four Central Bank Responsibilities are also observed.

Main findings

94. **The Serbian payment system is governed by a legal framework made up of a three-tier hierarchy, complemented by contractual agreements.** The first tier is based on laws adopted by the Parliament. The second tier is the set of NBS decisions adopted on the basis of tier one legislation. The third tier refers to rules, instructions and guidelines adopted on the basis of tier two decisions. The relevant legal, technical, operational and organizational issues important for the RTGS system are set forth in a complex set of legal documents. Ideally, all relevant provisions would be brought together for easy reference in one or two clear and well organized legal documents. However, where such codification is not feasible, the NBS could usefully establish a comprehensive register listing all legal documents relevant for payment systems and distribute it to all participants.

95. **The rules and procedures as regards credit and liquidity risk management, information on the system's design, its work schedule, and the procedures of technical and operational risk management are set forth in laws and by-laws.** The NBS is subject to credit risk to the extent it provides credit to participants; however, this risk is mitigated by required collateral to which haircuts are applied. As to legal risk, the moment when a payment becomes irrevocable and the time of finality are defined in the Law on Payment Transactions. Procedures for the management of technical and operational risks are set out to some extent in the system documentation. As regards liquidity risk, the documentation sets out that banks can use in full their reserve holdings for transaction purposes during the day (while maintaining at a minimum 80 percent of their required reserved at the end of each day). Reserves held with the central bank and used intraday provide ample liquidity for the RTGS system. Moreover, banks can obtain intraday credit from the central bank (against eligible collateral). Where necessary, banks can also obtain overnight or longer term credit from the central bank. The rules applying to the NBS RTGS and Clearing systems require that participants block funds in advance for such settlement operations.

96. **The NBS RTGS system has proved to be a stable and reliable system with a very good track record as regards availability.** The system's security framework is based on a number of policies and procedural requirements governing the levels of security demanded of the system, communication networks and participants. Operational, technical and risk management procedures are defined, documented and reviewed periodically. The system architecture consists of a main site, a hot back-up site, a disaster recovery site and a test site. Any significant change of system components is documented, authorized, controlled and tested. The RTGS system is subject to both internal and external audit. Internal audit is frequent, but concentrated merely on IT issues. To ensure continued high availability, it is important that the NBS develops a risk analysis methodology and that a risk analysis then be made regularly.

97. **Business continuity arrangements are documented and prescribed for each key component of the system.** However, the system has not been subject to a comprehensive risk analysis. Moreover, while business continuity procedures have been tested in the past, such tests are not foreseen to be conducted on a regular basis. Business continuity procedures should be tested regularly.

Recommended actions

98. **There are no recommendations in view of achieving full adherence to the Core Principles.** There are, however, the mission believes that the NBS could refine the system as follows to further improve existing arrangements:

- Improve codification of the legal, technical, operational and organizational documentation would help ensure clarity and understanding of the payment system. This could be achieved by bringing together for easy reference all relevant provisions in one or two clear and well organized legal documents or, at a minimum, by establishing a comprehensive up-to-date list on all relevant documents and distributing the list to all participants;

- Develop a risk analysis methodology and regularly undertake risk analysis to ensure continued high availability of the RTGS system. In addition, business continuity procedures should be tested regularly;

- Prepare for publication a single document explaining its main payment systems objectives and policies to provide for clarity and facilitate understanding,; and,

- Build up competence in the field of securities clearing and settlement and progressively develop a cooperation and oversight relation with the Securities Commission.

Authorities' response

99. **The findings of this assessment were discussed fully with the NBS during the FSAP mission in April 2005.** The NBS agreed with the assessment. No written comments were received from the authorities.

BANKING SECTOR FINANCIAL SOUNDNESS INDICATORS
(2002–05)

	2002	2003	2004	June 2005
Capital Adequacy				
Capital to risk-weighted assets	25.6	31.1	27.9	25.2
Tier 1 capital to risk-weighted assets	18.1	29.8	25.6	22.6
Total regulatory capital to total assets	18.3	22.5	18.8	17.2
Asset Quality				
Nonperforming loans to total loans (including off-balance sheet)	21.6	24.1	22.8	22.5
Nonperforming loans net of provision to capital	36.0	38.0	49.1	47.4
FX denominated and FX indexed loans to total loans	49.7	63.3	69.9	73.1
Earnings and Profitability				
Net Income to average assets (ROA)	-8.4	-0.3	-1.2	0.9
Net income to average capital (ROE)	-60.6	-1.2	-5.3	5.4
Net interest income to average total assets	5.6	6.0	6.4	6.2
Personnel expense to gross income	n.a.	10.5	9.3	7.6
Interest income to gross income	45.6	24.3	22.6	20.2
Noninterest income to gross income	54.4	75.7	77.4	79.8
Personnel expenses to noninterest expenses	n.a.	9.5	7.0	6.56
Customer deposits to total loans	118.4	115.0	97.5	99.2
Liquidity				
Liquid assets to total assets	25.7	20.0	21.0	15.1

Source: NBS

SUMMARY TABLE OF RECOMMENDATIONS OF APRIL FSAP MISSION

Recommended Measures of Final Aide-Mémoire	*Responsible Entity*	*Status of Implementation as of December 2005*
Banks and Banking Supervision		
Short term		
Adopt a time bound corrective action plan to address deficiencies in compliance with Basel Core Principles.	NBS	Done. The Second Phase Supervisory Development Plan was adopted in October 2005.
Ensure banks provide the NBS with accurate asset classifications on their loans.	NBS	NBS has indicated that it plans to implement in by-laws pursuant to the new LOB.
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	NBS has indicated that it plans to implement in by-laws pursuant to the new LOB.
Undertake full-scope examination of the largest state banks and ensure that recommendations arising from examinations are adopted.	NBS	Under way
Bring forward the privatization agenda for the two large state-controlled banks.	MOF/DIA	The tender for the largest state bank was issued in September 2005, while a time bound privatization strategy for the other large state bank has not been established.
Long term		
Strengthen all state controlled banks' reporting requirements.	MOF/DIA	Under way
Revise NBS chart of accounts to conform to IFRS accounting principles.	NBS	Not done
Require bank boards to have audit committees comprising a majority of independent members.	NBS	The new 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	Not done
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).

Recommended Measures of Final Aide-Mémoire	*Responsible Entity*	*Status of Implementation as of December 2005*
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)
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	Under way
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.
Monetary Policy		
Introduce a single, fully collateralized lender of last resort facility priced at a multiple of the market rate.	NBS	NBS has issued new regulations that unify the three existing lending facilities 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 is committed to lower the minimum to 50 percent during 2006.
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 GDDS.	NBS/NOS	Not done

Recommended Measures of Final Aide-Mémoire	*Responsible Entity*	*Status of Implementation as of December 2005*
Financial sector development		
Increase transparency of ownership and control of traded companies.	SC	Some measures are under way.
Require publication of the full IFRS audit report, supporting schedules and auditor's opinion.	NBS	Done in new LOB (Article 61).
Strengthen the responsibility and accountability of supervisory boards.	SC/MOF	Done in new LOB (Articles 31, 73, 137, 141).
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	Results of full on-site examination of DDOR are being reviewed; the NBS will complete a full scope on-site inspection of Dunav by end-2005.
Require DDOR and Dunav each to submit their business plans and appoint financial advisors to develop and execute a privatization strategy.	DIA	For DDOR, a list of potential privatization advisors was approved in December 2005; for Dunav, a time-bound corrective action plan was adopted in November 2005.
Develop a strategy for funding Third Party Liability Insurance under the guarantee arrangement.	NBS	A draft Third Party Liability Law is under consultation
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	A draft strategy is under consultation.
Strengthen the SC's legal authority and institutional capacity.	SC	Institutional capacity enhanced by reorganization and introduction of new remuneration guidelines in July 2005.
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

Recommended Measures of Final Aide-Mémoire	***Responsible Entity***	***Status of Implementation as of December 2005***
Modify accounting and auditing legislation and regulations to enable the implementation of the policy recommendations of the Accounting and Auditing ROSC	MOF/NBS	A new Law on Accountancy and Auditing is under discussion.