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REPUBLIC OF SERBIA

CRISIS MANAGEMENT FRAMEWORK

TECHNICAL NOTE

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I. BACKGROUND

1. **In light of the banking crisis in Serbia in late 2008 and early 2009, a series of measures were introduced to urgently address stability concerns.** These measures included increased deposit insurance coverage, shortened payout periods, introduction of lender of the last resort (LOLR) and new liquidity lines, and the possibility for Government of Serbia (GOS) to recapitalize insolvent banks. At the time it was understood that, once stability returned, it would be prudent to have a crisis management framework in place at all time to address systemic financial crises, much like some countries have a framework to deal with natural disasters. The new framework would replace the need for *ad hoc* measures during crises. This technical note has been prepared in the context of the initiative, primarily spearheaded by the NBS, to develop a contingency management framework. In particular, the note addresses what ought to be the key elements of such a framework and how the National Bank of Serbia (NBS) and other countries are tackling such contingency planning.

A. Key Elements of a Crisis Management Framework

2. **An effective crisis management framework should include a clear decision making process and a definition of responsibilities for the various institutions involved in crisis resolution.** The objectives of any crisis management framework are to halt the crisis about to unfold, or already unfolding, and to minimize its impact. Hence, speed is of the essence. To ensure that the objectives are met, a clear process for decision making, including an unequivocal identification of the decision making authorities, and of their alternate, ought to be identified. The entities involved in the framework vary depending on the local set up, but should involve the central bank, supervisory entities, institution in charge of bank resolution, deposit insurance agency and Ministry of Finance (MOF). Moreover, if foreign banks are important players in the country, home supervisors should also be involved in the framework. The decision making process and definition of responsibilities amongst the various entities are usually enshrined in laws and memoranda of understanding (MOUs).

3. **A comprehensive framework includes a menu of measures to enhance market confidence and liquidity provision, strengthen the balance sheet of undercapitalized banks, and facilitate loan restructuring.** Measures to enhance market confidence include primarily blanket guarantees with various degree of coverage. Liquidity measures include enhanced LOLR facilities, establishment of foreign exchange (FX) swap facilities and relaxation of mandatory reserves. Balance sheet strengthening measures include diagnostic tools, resolution arrangements (including an adequate framework, human resources to implement such framework and resources to fund resolution). Finally, the framework should facilitate restructuring of the banks' loan portfolio by giving incentives to the banks to do so and giving breathing space to banks borrowers to repay.

4. **These measures need to be designed in a way that provides latitude of implementation, credibility, sustainability, and an exit strategy.** The exact mix of measures

required and the extent to which each measure will be required is not known until each crisis hits. Hence, in designing a crisis framework, the authorities should give themselves the maximum latitude of operation. Crisis management framework aim at stopping the panic amongst the population, market participants and investors, thus measures adopted under such framework need to be credible (see Box 1). However, crisis resolution often requires substantial financial resources, therefore measures under the framework need to take into account the fiscal situation of the country. Finally, in addition to being expensive, measures introduced in crisis management framework can distort market dynamics in normal times, for example through moral hazard. Hence, any risk management framework needs to include a clear exit strategy (see Box 1).

Box 1. Credibility and Exit from Blanket Guarantees

Many countries have announced measures to lessen the impact of the current financial crisis. Most programs include the introduction of blanket guarantees with various degree of coverage of the liabilities.

Blanket guarantees have played a crucial role in containing past crises; some forms of guarantee were introduced in the financial sector crisis that unfolded in the 1990s in Finland, Indonesia, Japan, Korea, Sweden, and Turkey. The success of blanket guarantees hinges fundamentally on the credibility of the authorities commitment to take action to avert a financial meltdown. In some country a simple policy announcement can carry such credibility, in others a policy announcement needs to be swiftly followed by a legal commitment. In all the countries listed above political announcements were immediately formalized in a law, except for Turkey in which the policy announcement was translated into law only years later.

While guarantees give governments time to develop suitable policy responses, are easy to implement, and have no up-front fiscal costs, overtime they lead to moral hazard, and large fiscal contingent liabilities. To address this issue, a number of countries that have introduced guarantees on liabilities in the context of the current crisis have also included sunset clauses. These include Australia (3 years); Denmark (2 years); Greece (initially blanket, then up to EUR 100,000 for three years); Hong Kong (untill 2010); Ireland (September 2010); Malaysia (December 2010); New Zealand (2 years); Singapore (December 2010), UAE (3 years), Mongolia (5 years).

Source: World Bank Crisis Response Note 1 and 4, IMF Global Policy Responses to Financial Crisis.

B. The Serbian Crisis Management Framework

5. **In response to the deposit outflow of October 2008, GOS enhanced existing market confidence by increasing deposit insurance coverage and shortening payout period.** By amending the Law on Deposit insurance and the Law on the Deposit Insurance Agency, the GOS (i) increased the deposit insurance coverage from EUR 3,000 to 50,000 per depositor per bank; (ii) expanded coverage to include small and medium legal entities and sole entrepreneurs; and (iii) shortened the period by which the Deposit Insurance Agency (DIA) has to start paying insured depositors from 30 days to three days.

6. **Subsequently, and in conjunction with the IMF-supported program, the GOS launched a voluntary financial sector support program (FSSP).** The program is voluntary and opened to all banks (see Box 2). The program is enshrined in commitment letters (to maintain exposures in Serbia and adequate level of capitalization) signed by home/host

supervisors and participating banks, and an MOU between the MOF, the NBS and the DIA regulating information sharing and coordination in times of crisis. A confidential Annex has been appended to the MOU to identify a roadmap for bank resolution and the key elements of a LOLR facility. To implement the Annex, NBS issued a number of regulations introducing a LOLR facility, additional facilities for liquidity provision, and provided incentives for loan restructuring. Details of the measures introduced under FSSP in each of the five pillars are presented below.

7. **Measures adopted in the context of the FSSP to enhance liquidity provision include the introduction of LOLR and new liquidity lines.** The LOLR facility (not previously available in Serbia) can be extended for up to one year at 150 percent of the policy rate to solvent banks against selected liquid collateral. All banks operating in Serbia are eligible (as opposed to those participating in the FSSP). Recognizing the tighter liquidity conditions in times of crisis, the NBS also introduced two new liquidity facilities for banks that participate in the FSSP: (i) an extended dinar liquidity facility to help banks with loan restructuring; and (ii) an FX swap facility with a two week maturity and an implicit roll over guarantee. Further details on these measures and recommendations on the same are provided in the Liquidity Technical Note.

8. **Measures to strengthen the balance sheet of undercapitalized banks under the FSSP include a diagnostic tool and a resolution roadmap.** The NBS has developed a two-phased stress testing methodology. In the first phase, the NBS undertakes on-site inspections focusing on the performance of the loan portfolio. In the second phase, the NBS performs stress testing based on a downward scenario on the adjusted bank statements. Based on the diagnostic results, the resolution roadmap included in the MOU Annex divides banks in three categories: banks that can raise private funding to increase capital adequacy ratio (CAR) to 12 percent (type 1); banks that can apply for capital injection from the state (type 2); and banks that will be liquidated (type 3). Banks that qualify to receive capital injection from the state are systemic banks, defined as banks that have a CAR of less than 2 percent of the total assets and 1 percent of retail deposits. Based on this definition there are 19 systemic banks in Serbia out of 34. Non-systemic banks which are deemed viable by the NBS can also benefit from public recapitalization but only up to 50 percent of the capital required.

9. **To increase loan restructuring, loan loss provisioning has been relaxed for restructured loans.** Banks that participate in the FSSP can restructure their loan by stretching the remaining loan maturity by at least 12 months or reducing monthly payments by 20 percent. For such loans lower loan loss provisioning is required.

Box 2. Key Elements of the FSSP

Twenty-seven banks operating in Serbia (out of 34) have signed up to the program, which involves a mix of commitments and incentives. The program expires in 2010 and requires banks to: (i) obtain specific commitments from parent bank groups to keep their exposure vis-à-vis Serbia at end-2008 levels throughout 2009–10, subject to a review at end-2009 (this applies only to foreign subsidiaries); (ii) keep sufficient level of capitalization and liquidity; and (iii) participate in a stress test exercise based on IMF methodology and a downside scenario. The NBS expects to complete the diagnostic studies for all banks by end-2009. Subsidiaries and local banks participating in the program have been asked to facilitate voluntary conversion of FX and FX-linked loans into local currency loans, and work with the NBS toward developing a common loan workout scheme that would avoid unnecessary blockage of delinquent but solvent borrowers' accounts. They are also required to facilitate loan restructuring under a pre-agreed framework, which requires the extension of remaining loan maturity by at least 12 months or 20 percent with reduced monthly payments, or any other restructuring lowering monthly payments by at least 20 percent.

In terms of incentives, the participating banks have been granted access to two new liquidity facilities: (i) an extended dinar liquidity facility and (ii) an FX swap facility. The first aims to help banks with loan restructuring and will involve provision of dinar loans with maturities of up to a year, under a broad range of collateral and with a non-penalty interest rate. The FX swap facility offers each bank a swap line out of a designated pool of funds of up to EUR 1 billion. Swaps are offered with a two-week maturity and an implicit rollover guarantee. The NBS has amended regulations related to risk management to facilitate fulfillment of the commitments. In particular, the NBS has raised the limit on subordinated debt-to-Tier I capital ratio from 50 to 75 percent and the net open position from 10 to 20 percent of capital.

10. **To deal with financial crises in the future, a Law on Banking Sector Stability has been drafted.** The main purpose of the Law is to provide an *ex-ante* framework for coping with future financial catastrophes. Consequently, the law would be similar to emergency laws in place in many countries to deal with natural disasters, like earthquakes or flooding, or national security threats. The Law provides a framework that allows the GOS to respond quickly with a range of pre-determined tools and without further parliamentary approval once certain triggers are activated. Parliamentary approval on the basis of urgent procedure is however required when budget resources are needed.

11. **While the Law on Banking Sector Stability will be enacted permanently, the measures listed in the law can be implemented only when a crisis has been declared.** Based on the law, GOS (upon NBS proposal) can declare a systemic crisis, subject to prior opinion of MOF and DIA. Under such circumstances, blanket guarantee on all deposits and, if needed all bank liabilities, can be extended. The cost test for bank resolution can be waived and funding for financial assistance is to be authorized by an extraordinary session of the Parliament. GOS equity, acquired as a result of providing financial assistance to troubled banks, needs to be divested within a year. To enhance LOLR facilities available in normal times (Reg. 96/2008), NBS can request that GOS issue a guarantee to solvent banks with insufficient collateral or to significantly undercapitalized systemic banks. GOS guarantee would be given against bank

collateral that includes mortgages (up to 70 percent of book or market value—whichever is lower), receivables (up to 60 percent of book value) and acceptable securities. During a systemic crisis, the GOS is required to report on measures undertaken to the Parliament once per month. A systemic crisis situation is revoked by the GOS upon NBS or DIA suggestion.

C. Recommendations of the Crisis Management Framework

12. **The legal provisions included in the Law on Banking Sector Stability meet best practice criteria.** The proposed legal provisions include almost all pillars of a comprehensive framework (namely enhancement of market confidence, liquidity provision, and strengthening the balance sheets of undercapitalized banks). The provisions also provide for enough latitude of implementation (all measures can be triggered in various degrees) and include an exit strategy. As such they meet what is considered best practice. Other benefits derived from the approval of the provisions include: (i) capacity to use crisis tools without further Parliamentary approval; (ii) credibility of adopted measures[1]; and, (iii) enhanced coordination and cooperation between the GOS and the NBS by requiring them to work together to declare a systemic crisis. The only downside derived from the approval of such provisions is that, if not well explained, they could trigger market and public anxiety.

13. **Other countries have included similar systemic crisis provisions in their legal framework.** Some countries have included such provisions in the existing legal framework (e.g., the US Federal Deposit Insurance Act), others have, or are in process of, including provisions in so-called crisis laws (e.g. Lithuania and Brazil - the latter is still drafting such a law). Systemic crisis provisions are applicable only in times of crisis and allow for state funds for recapitalization of banks (e.g., Lithuania), abolishing the cost test for bank resolutions (e.g., the US), and for different degrees of guarantees on deposits or other liabilities (e.g.. the US, Lithuania, Brazil). A determination is made as to a crisis situation by some combination of the MOF and initiated/in consultation with the central bank, and deposit insurance agency.

14. **Whether the proposed legal provisions should be included in one law or be introduced by amending a number of laws is a matter of legal drafting.** The provisions included in the Law on Banking Sector Stability could be approved as a standalone law (e.g., Lithuania) or as amendments to different laws to which these provisions create exceptions applicable in times of crisis (e.g., the US). Various countries have followed different routes and such decisions really rest on the legal drafting tradition of each country. However, the inclusion of a complete framework in a single law makes the framework particularly transparent.

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[1] That is, it avoids necessity of public announcement of policy followed by the uncertainty of Parliamentary action. It should be noted that in Serbia it took Parliament three months to enact an increase in deposit insurance in late 2008.

15. **In addition to approving the proposed legal provisions, the high deposit coverage introduced in the wake of the deposit outflow should be decreased gradually.** The deposit insurance coverage was introduced as an *extrema ratio* to stem the deposit outflow in October 08. However, the measure is not credible (the DIA has enough resources to cover the deposits of any of the 20 smallest banks individually, or the sum of the smallest 9, and has no emergency funding arrangements) and in the long run it might encourage market participants to take excessive risk (under the new limit, 99 percent of the deposit in number and 90 percent in volume are covered). A carefully calibrated policy mix is required to address these shortcomings: (i) approval of legal provisions that allow for various degree of blanket guarantees; (ii) reduction of coverage level with carefully managed public information campaign; and (iii) establishment of an emergency funding arrangement for the DIA should a medium/large bank be liquidated. Other measures introduced in the wake of the October deposit run to speed up deposit repayment are also not credible; more detailed recommendations are included in the Deposit Insurance Technical Note.

16. **While the legal provisions proposed in the Law on Banking Sector Stability are adequate some minor amendments are recommended.** These include (i) rapid approval of GOS guarantees for LOLR and flexibility in determining collateral and haircuts for LOLR; (ii) removal of resolution roadmap that makes almost all undercapitalized banks eligible for recapitalization with GOS funding; (iii) adoption of legal amendments that allow institutions other than banks to carry loans on their balance sheets; and, (iv) development of MOUs on crisis management with the home jurisdictions of the largest investors in the country. Finally, to implement the legal provisions and identify systemic crisis, the NBS should develop a systemic risk assessment. More detailed recommendations on each are provided below.

17. **Enhanced LOLR measures should include provision to rapidly obtain GOS guarantees, and respective collateral and haircuts should not be prescribed in the law.** A provision to obtain the GOS guarantee for banks without adequate collateral under urgent Parliamentary procedure should be included in the draft Law. Moreover, no list of adequate collateral or allowed haircut for the GOS guarantee should be included in the law, as these might change over time. It is also advisable to restrict the list of collateral allowed for LOLR in normal times (defined in NBS regulation) and to expand the list for crisis times.

18. **The resolution mapping included needs to be updated in light of the new resolution tools available and potential blanket guarantee available during crises.** The proposed bank resolution tools (applicable both in normal and crisis times) include a comprehensive definition of financial assistance. The definition includes all required tools, except for guarantees on debt issue for banks that are not in receivership, as financial assistance can be provided only to intervened banks. The objective of the resolution mapping included in the Annex to the crisis MOU is to promote stability by protecting all liabilities in the largest banks. Due to the introduction of proposed resolution tools (see Bank Resolution Section) and the Law on Banking Sector Stability, the same objective can be achieved in a less costly fashion. Hence, the Annex needs to be amended to be brought in line with the new resolution and crisis framework.

19. **To incentivize banks to restructure loans, the blocked account system needs to be restructured and the legal impediments to a secondary loan market need to be removed.** NBS regulations aimed at promoting loan restructuring on an individual bank basis can have limited impact due to the blocked account system, which de facto requires a multi-party workout process. Recommendations on how to improve the systems are presented in the Corporate Credit technical note. Moreover, only banks are allowed to carry loans on their balance sheet and as a result no secondary market for loans exists in the country (see Bank Resolution Technical note). Consequently measures to incentivize banks to clean up their loan books cannot have much impact.

20. **It is recommended that crisis management MOUs be urgently developed with the most important home supervisors.** In light of the importance of foreign banks in the Serbian market, it is paramount that the authorities develop MOUs on crisis management with the home jurisdictions of the largest investors in the country. The urgency of the recommendation is heightened by the fact that no MOUs for non-crisis situation have been developed with these authorities. As a result, the Serbian and relevant home authority do not have a basis of cooperation to start from, as a crisis management framework works best if built on cooperation in normal times. Key features of successful MOU on crisis management are presented in Box 3 below.

Box 3. MOU on Crisis Management Between the Nordic Countries

The MOU on management of financial crisis in banks with cross border establishments between the Nordic countries is considered a best practice example. Key elements of this MOU include:

Regular and formalized exchange of information and cooperation between home and host supervisors. The MOU on crisis management is effective as there is cooperation on paper and in practice in normal times. Trust and communication channels are crucial to ensure speed action in times of crisis. Only by having regular cooperation in normal times and familiarity amongst the supervisors there can be effective cooperation in time of crisis.

Clear division of responsibilities between host and home supervisors and amongst home and host country entities involved in crisis management (e.g., Ministry of finance, Central Bank, deposit insurance funds and resolution agencies). Key issues on which a division of responsibility is spelt out include: who will take the lead on liquidity provision, on solvency determination, and on bank intervention (i.e., should a TA be introduced or should staff from the parent bank take over the bank?)

Basic element of burden sharing for liquidity and solvency.

Source: Management of a financial crisis in banks with cross border establishments—Memorandum of Understanding between the central banks of Denmark, Finland, Iceland, Norway and Sweden.

21. **Finally, to implement the provisions included in the Law on Banking Sector Stability, and identify systemic crisis, NBS should develop a systemic risk assessment.** To single out a systemic crisis, the NBS should: (i) identify the critical elements of the financial system, i.e. systemically important banks, critically important financial infrastructure and key financial markets (liquidity sources and markets for risk management); (ii) define a contagion channel matrix, which identifies contagion channels between various elements of the financial

system and the real sector; and (iii) appoint a unit that is in charge of monitoring systemic risk based on framework provided by (i) and (ii).