FINANCIAL SECTOR ASSESSMENT
SERBIA

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EUROPE AND CENTRAL ASIA REGION VICE PRESIDENCY
FINANCIAL SECTOR VICE PRESIDENCY

BASED ON THE JOINT IMF-WORLD BANK FINANCIAL SECTOR ASSESSMENT PROGRAM

BACKGROUND

1. As part of the Bank-Fund Financial Sector Assessment Program (FSAP), two missions visited Serbia, one in March 2005, and the second from April 12 to 26, 2005. The purpose of the FSAP was to assess the strengths and vulnerabilities of the financial sector and to identify key areas for its further development. The team met with the Ministry of Finance (MOF), National Bank of Serbia (NBS), Bank Rehabilitation Agency (BRA), commercial banks, insurance companies, and many other officials. The team produced several reports that were reviewed by and delivered to the authorities. Our findings are set out in this Financial Sector Assessment and our policy recommendations summarized in the Annex.

STRATEGIC ASSESSMENT OF STABILITY AND DEVELOPMENT ISSUES

2. The team concluded that the financial system is currently broadly stable, but that there are systemic risks which could come to the fore if the rapid pace of credit growth continues. Credit to companies and households grew by 13 percent of GDP during 2004. The credit surge fosters economic recovery and growth, and was made possible by the authorities' strong reform program, which is impressive in the light of recent history. However, rapid credit growth brings new risks to financial and macroeconomic stability, especially in the context of the very large current account deficit and high inflation. At the same time, the still low level of bank credit and the rather undeveloped non-bank financial sector indicates ample scope for further financial development.

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

2 These were an Aide Mémoire, Technical Notes, and Detailed Assessments of Compliance with Standards and Codes.
3. Policies to support financial stability and development should focus principally on bank supervision and the legal framework. The Basel Core Principles assessment of bank supervision was unfavorable, despite recent progress. Bank supervision should be improved by consolidating recent enhancements in the institutional capacity of the Bank Supervision Department, by adoption of the new banking law, and new regulations that address credit risks by strengthening enforcement and risk management. Many legal measures are needed to improve governance and ensure that banks do not take actions that could increase systemic vulnerabilities, while developing insurance, pensions and capital markets. Since May 2005 the authorities have implemented many FSAP recommendations (see Annex).

Systemic vulnerabilities

4. Significant systemic vulnerabilities are bank credit risk and the large state-owned banks. The consequences of those systemic risks would overlap and could amplify considerably in the absence of sound macroeconomic and structural policies.

5. Credit risks arise from the 47 percent nominal growth in bank loans during 2004 – most of which comprises foreign exchange indexed loans to borrowers with dinar income. Stress test results indicate that credit risk is the most significant risk for the system. To mitigate credit risk, the team recommends better data reporting, new provisioning requirements, improved bank governance, and further strengthening of the supervision and enforcement functions.

6. The state banks are not competitive with foreign banks and their performance should be improved substantially ahead of privatization. Their relatively weak financial condition suggests that a major credit shock could put severe pressure on their loan portfolios and capital base, and a narrowing of margins arising from greater competition would create losses and induce under-capitalization. The risks should be addressed by resolute enforcement of supervisory examinations; better data reporting, internal controls, risk management and governance; and the continuation of rapid privatization.

7. Banking supervision has improved, especially data collection and analysis, but high staff turnover and weak enforcement have undermined its effectiveness. Weak enforcement has been a legacy of recent history, lingering state control of several key banks, gaps in the legislation, and the vagaries of the judicial system. The risk-based approach to supervision has not yet taken hold, and consolidated supervision of banking groups also needs to be introduced. Off-site analysis, AML measures and inter-agency cooperation should also be strengthened.

8. Greater stability would be supported by stronger bank governance. The ability of the NBS to apply “fit-and-proper” criteria for directors and significant shareholders should be enhanced, and the threshold for requiring NBS approval for changes in ownership tightened. Bank directors should be held accountable for material misstatements of financial position and the NBS should be empowered to apply remedial actions and sanctions in cases of financial misreporting. Internal and external audit provisions relating to banks should be expanded and strengthened.
Financial development

9. The team concluded that financial development is unbalanced, reflecting gaps in the legal and regulatory framework. Foreign bank lending and leasing are both growing sharply, and state bank privatization is underway, but non-bank financial markets are either small or nonexistent.

10. Policies are underway to remove impediments to the development of the nascent insurance sector. The industry is dominated by two large state insurers, which are scheduled for restructuring and privatization. The Insurance Supervision Department has required them to prepare business plans prior to full on-site inspections. The growing life sector is marked by unscrupulous practices and the relevant prudential rules need strengthening. However, the department has begun an impressive work program and has closed fifteen insurers, while the BRA now oversees insurer liquidation and bankruptcy.

11. Creation of a supporting legal framework is presently the main issue for capital markets. The authorities are undertaking reforms to modernize the regulatory and institutional framework. Market participants must be required to adhere to high standards of accountability and transparency.

12. Monetary policy effectiveness would be strengthened by adjustments to the monetary operation framework and the establishment of an interest rate corridor. The MFP Transparency Assessment notes that policy effectiveness would benefit from greater public disclosure of the broad objectives and intermediate targets. The RTGS system is highly reliable and efficient, and is fully compliant with the Core Principles for Systemically Important Payment Systems (CPSIPS).

Legal and business environment

13. The legal framework has inconsistencies and gaps, but many new laws have been passed or are under consideration. New Company, Secured Transactions, and Bankruptcy Procedure laws have been passed, but not yet implemented. A draft Land Law has been drafted. A Law on the Bankruptcy and Liquidation of Banks and Insurance Companies was approved by the parliament on July 15, 2005.

14. Much work remains to be done on the corporate governance framework. Registration of new companies has been much improved, but weaknesses remain in the transparency of ownership, financial reporting, board responsibilities, minority shareholder protection in capital dilution and corporate takeovers. The securities regulator suffers from insufficient legal authority and weak institutional capacity. Investment funds remain unregulated and pose a risk for future private pension funds. Revised legislation and a strengthening of the regulatory agencies are both required.

15. The authorities should eliminate discrepancies between general-purpose financial reporting under International Financial Reporting Standards (IFRS) and regulatory reporting. The Accounting and Auditing Law (2002) requires all enterprises to follow IFRS, but enterprises must adhere to standard forms or grids for the regulators which do not comply with IFRS. This fosters a “form over substance” attitude to financial reporting, and precludes
The current state of the financial sector is best understood against the background of the 1990s. The politically distorted and war-influenced management of the economy during those years created large fiscal and external imbalances, resulting in hyperinflation, large public debt and a shrunken financial sector. In 1991, the government took over most foreign currency savings of households, and many households lost their deposits as a result of large-scale pyramid schemes. International sanctions from mid-1992 until October 2000 led to isolation and the loss of official external financial support.

Since the fall of the previous regime, Serbia has made good progress in macroeconomic stabilization. The exchange rate-based stabilization program has helped to reduce inflation from 115 percent in December 2000 to 8 percent at end-2003. The favorable disinflation trend was supported by a notable reduction in the government deficit. However, despite average non-agricultural growth of about 5 percent per year since 2002, output is only slightly above half of its pre-transition level.

Recent macroeconomic imbalances have put at risk earlier achievements. By mid-2005 inflation had doubled to 17.5 percent, owing to robust domestic demand driven by rapid wage and credit growth, administrative price increases, and higher oil prices. Owing to strong domestic demand and a large trade deficit, the current account deficit of Serbia and Montenegro relative to GDP widened from 9.7 percent in 2001 to 15.5 percent in 2004, which is too high, given the rise in foreign borrowing to pay for imports. Total external debt at end-2004 of US$14 billion (62 percent of GDP) was unchanged, despite the debt reduction by the London Club and other creditors equivalent to 7 percent of GDP.

Re-monetization and a rapid expansion in the market share of foreign-owned banks have contributed to fast credit growth, while rising euroization has also increased vulnerabilities. Buoyant growth in foreign-currency deposits, partially fed by remittances, and the surge in foreign borrowing by commercial banks financed a credit boom in 2004 that contributed to the deterioration in the current account deficit. Euro-indexed lending has increased banks’ credit risk resulting from their borrowers’ exposure to exchange rate risk. The tightening of monetary policy since mid-2004 resulted in a moderate decline in reserve money, but strong broad-money growth has continued unabated. High euroization undermines the impact of changes in policy interest rates on bank lending rates, domestic demand and inflation. To compensate, the NBS has resorted to macro prudential measures to slow down credit growth with a view to helping contain domestic demand and the current account deficit.

Macroeconomic imbalances are rooted in structural problems in state- and socially-owned enterprises which account for 50 percent of GDP. Weak financial discipline in those enterprises has led to rapid wage increases, and their low productivity hampers the growth of exports and GDP, so their restructuring and privatization should be accelerated. It is essential to reduce overstaffing and to initiate bankruptcy procedures against unviable, socially owned enterprises that are unable to attract investors.
FINANCIAL SECTOR OVERVIEW

21. The financial sector is small and bank-dominated, equivalent to some 48 percent of GDP, which is low by regional standards. The 43 licensed banks as of end-2004 represented 90 percent of the financial system, with total assets of SRD 510 billion (€6.45 billion), which was 40 percent of GDP. Leasing company assets accounted for 2.1 percent of GDP, while the assets of non-bank credit institutions were tiny (0.2 percent of GDP). The insurance sector had total assets of €430 million at end-2004, largely reflecting non-life activities, with a penetration (premium/GDP ratio) of 2.1 percent.

22. Since 2000 the banking system has undergone consolidation and re-nationalization. In 2001 19 relatively small and undercapitalized banks were closed. The BRA was given authority to administer banks in bankruptcy and in January 2002 four large state-owned banks (accounting for 57 percent of banking sector assets) were resolved. A debt-for-equity swap by the government in 2002 to resolve the debt owed by Serbian banks to Paris and London Club governments and banks caused a partial re-nationalization of the banking system.

23. Bank ownership is undergoing a fundamental change from state-controlled to private and foreign-owned. Six state-owned banks (17 percent of total bank assets) are now passing through the BRA-managed bank privatization program, of which the first was completed in January 2005. Domestic private banks include one large, relatively dynamic bank and a number of small banks. Twelve foreign banks have entered the market since 2001, through greenfield investments or acquisition, raising the foreign share of total banking assets from around 38 percent (end-2004) to around 50 percent (mid-2005).

24. The insurance industry is small and underdeveloped. Half the insurers have been closed since mid 2004, largely owing to insolvency, failure to pay claims, or inability to meet the higher minimum capital requirements. More rationalization can be expected, as market conduct improves and prudential supervision becomes more institutionalized. The two largest insurers are slated for privatization. Currently, the industry is characterized by poor governance and inadequate risk management practices. Consumer confidence is lacking, primarily owing to nonpayment of motor third-party liability claims.

25. Leasing activity is growing sharply. The eight-fold growth of leasing assets in 2004 to €350 million was attributable to the foreign-owned leasing companies registered in 2003–2004. One-third of new financial leasing investment was spent on cars and office equipment for SMEs and households.

26. The equity market is very small, the money market is segmented and underdeveloped, and there are no domestic corporate bond and paper markets. The government auctions 91-day and 182-day T-bills regularly, but primary and secondary T-bill markets are small, with outstanding stock at end-March 2005 of only SRD 7 billion (€88.1 million). The largest issues are the euro-denominated Frozen Foreign Currency Bonds (FFCBs) in the amount of €2.8 billion.
Systemic risks

27. Financial vulnerability analysis identified two main systemic risks. First, the high proportion of foreign currency-indexed loans exposes banks to credit risk shocks. Second, the large state-controlled banks pose potential systemic risks because they are less competitive than their peers.

28. Supportive macroeconomic and structural policies would minimize systemic risks. An acceleration of the reform program would strengthen financial stability by enhancing the dynamism of the economy, especially the export sector. A credible anti-inflationary framework, including tight monetary and fiscal policies, would dampen domestic demand, contain the current deficit and inflation, and encourage capital inflows. Conversely, a slowdown in reform would go hand-in-hand with a failure to contain domestic demand. Investors could reassess their exposure towards Serbia and assets denominated in SRD, creating pressure on the dinar and causing a slowdown in bank lending.

29. The team used stress tests based on September 2004 data to assess vulnerabilities, but the results likely understate the consequences of shocks owing to data issues. To the extent that banks under-report NPL levels and/or make insufficient loan loss provisions for problems identified, owing to asset classification deficiencies or partial noncompliance, their capital or overall financial position would be overstated. In this case, re-capitalization needs may well be underestimated.

30. The riskiness of banks' loan portfolios is increasing, owing to the 47 percent nominal growth in bank loans during 2004. Foreign banks are responsible for most of this credit growth which is predominantly foreign exchange indexed. This lending is being financed by new foreign exchange deposits, mainly by households, and by foreign exchange borrowing from banks' headquarters.

31. During the first half of 2005 NBS implemented measures to contain macroeconomic risks arising from rapid credit growth, but although consumer lending has now slowed, growth in credit to enterprises has remained robust. The NBS: (i) tightened conditions for consumer loans; (ii) broadened the reservable base to include commercial banks' foreign borrowing; (iii) increased the minimum capital adequacy ratio from 8 percent to 10 percent; (iv) eliminated remuneration on required reserves on enterprises' foreign currency deposits; (v) raised the Statutory Reserve Requirement (SRR) on enterprises' foreign currency deposits and on banks' foreign borrowing by 5 percentage points to 26 percent; (vi) lowered the SRR on dinar deposits by 1 percentage point to 20 percent; and (vii) required banks to monitor and assess borrower's exposure to exchange rate risk and to reflect their assessment in the loan classification.

32. Credit risk is high, as evidenced by the stock of NPLs which was 22.8 percent of total loans at end-2004. Direct credit risk is most acute for state-owned banks, as their 33.5 percent NPL ratio was higher than the 27 percent ratio for private banks or the 7 percent ratio for foreign banks. NPLs are likely to increase further in 2005 and 2006 across all banks, and
loan loss provisions will rise, as problems are recognized. This trend includes foreign banks whose lending has been growing the fastest.

33. Regional comparisons suggest that additional provisions are likely to be necessary in future, as NPLs that are not repaid or otherwise resolved migrate downwards over time to worse classification categories. The existing level of loan-loss provisions, especially at private banks (where only 38 percent of NPLs are provisioned), suggests bank capital may be overstated, although most banks appear to make loan loss provisions in accordance with present asset classification regulations.

34. Stress tests indicate that credit risk is the most significant risk for the system. A shock of 25 percent of NPLs downgraded to the next classification category suggests that the capital adequacy ratio (CAR) of five banks would fall to below 8 percent (including four state banks). The system would have a CAR loss of 6 percent after adjusting for additional provisions against Paris and London Club loans. State banks would lose 21 percent of their capital, requiring SRD 3.6 billion recapitalization.

35. The banking system is also exposed to indirect foreign exchange risk because most lending is in euros, or in dinars with a euro-index clause, which transfers the risks of dinar depreciation from the bank to the borrower. This has an indirect consequence for banks, as a sharp increase in debt-servicing requirements arising from a sudden depreciation will lead to higher NPLs. NBS data in April 2005 suggested that foreign currency-denominated and foreign currency-indexed loans represent 68 percent of the total, but this is likely an under-estimate, since anecdotal evidence based on annual reports and discussions with banks suggests that indexed loans have been underreported.

36. To mitigate direct and indirect credit risks the FSAP team has recommended technical measures related to risk management, portfolio classification, loan loss provisioning and reserve requirements. The risks identified would also be mitigated by measures to strengthen bank supervision.

Risks posed by state-controlled banks

37. The state banks are losing their competitive position against new foreign entrants and pose potential systemic risks ahead of their privatization. State banks' earnings are well below those of other banks owing to high NPLs, substantial loan loss provisioning and high administrative costs. Several state-controlled banks are significantly overstaffed compared with their private sector rivals. The banks remain vulnerable to further deterioration and unwarranted influence while in state hands. Once the current round of privatizations has been completed, 10 majority and minority state-owned banks will remain, most of which are slated to be sold. The state-owned banks will continue to require close surveillance not only by the NBS but also by the BRA, which has taken over the state's ownership responsibilities in those banks.
Other risks

38. The team analyzed other risks, which appear to warrant less attention from policymakers:

- Management of liquidity has not recently been a significant problem for banks, but stress tests suggest that although the system is relatively liquid, risks may arise from high concentrations of short-term deposits and the withdrawal of public deposits held with state banks.

- Stress tests indicated that the interest rate shock alone, arising from short-term maturity mismatches of assets and liabilities, does not pose a significant risk to the banking system.

- Leasing activity is equivalent to only 5 percent of banking assets. The rapid growth of leasing companies’ assets in 2004/2005 is being financed primarily by borrowing from their respective affiliated and parent banks, but this increased exposure is insufficient to pose a systemic risk.

- Risks may arise from a sudden cutback in lending by foreign banks which could slow GDP growth and lead indirectly to higher NPLs. However foreign bank entry is so recent that the risk of a rapid scaling-back of their activities seems low, at least in the short run.

- Corporate external borrowing, mostly by Serbian subsidiaries of multinationals, is around 4 percent of GDP, reflecting its low relative cost. An acceleration of corporate external borrowing could eventually pose risks to stability if large-scale corporate distress threatens domestic banks.

Prudential Supervision Issues

39. The NBS Bank Supervision Department (BSD) has made progress in enhancing its effectiveness, guided by a Supervisory Development Plan designed with external assistance. Important steps include new BSD management; formation of a Supervisory Review Committee to improve decision making; adoption of a supervisory operating policy and a standardized examination report format; improved communications within BSD; and the introduction of a CAMEL rating process.

40. However, the Basel Core Principles assessment of bank supervision was unfavorable. Out of 30 CPs, 19 were assessed as materially noncompliant, and one as noncompliant. Some BCPs were assessed as materially noncompliant because supervision was not being undertaken on a consolidated basis. However, in the new banking law consolidated supervision is fully defined, so compliance with several BCPs should improve once consolidated supervision is fully implemented. Poor corporate governance remains a major weakness, especially in domestic banks, as many boards of directors and supervisory boards do not institute proper systems for managing prudently the business risks incurred by the banks under their control. Many problems in banks have also been caused by the self-serving behavior of major shareholders. The NBS needs legal authority to vet the suitability of banks’ governing board members under strengthened “fit-and-proper” criteria, and to remove persons who lack the necessary skills and integrity. The NBS should be empowered to freeze the
exercise of voting rights by shareholders in serious cases, and the threshold at which a person or entity is deemed to have significant ownership in a bank should be reduced from 15 percent to 5 percent. Many of the measures to improve bank supervision will need to be incorporated in the new banking law presently being prepared.

41. **Recent successful appeals against NBS decisions by commercial banks and their owners in the courts indicate there are weaknesses in the legal system.** In addition, neither the NBS nor its officers have statutory protection against actions for damages when carrying out their duties in good faith. The new banking law should clarify the grounds for appeals and introduce specific legal protection for supervisory staff.

42. **Supervision of banks’ credit exposures to shareholders is weak.** There are many recorded instances of forbearance, including breaches of the limit for individual exposures (5 percent of capital), and no limit on a bank’s aggregate exposure to connected parties. The new banking law should make provision for such a limit below the EU level of 20 percent of capital. The NBS should also obtain legal powers to supervise banks on a consolidated basis, in order to capture risks incurred through banks’ financial subsidiaries such as brokers and leasing companies. There should be a separate limit on the aggregate amount in relation to capital of a bank’s investments in non-financial entities.

43. **Risk-based approaches to supervision are still underdeveloped.** Measures are needed to oblige governing boards of banks to establish integrated systems that identify, monitor, and control effectively all risks incurred in their activities. There are weaknesses in the NBS requirements for banks’ credit systems. First, loan-loss provisions are mostly established in accordance with regulatory prescriptions, rather than by an assessment of loan quality, including a borrower’s cash flow, earnings and repayment capability. Second, the requirements for restructured loans need to be strengthened to link upgrades to a demonstrated track record of repayments. The NBS also needs to ensure that banks’ systems capture non-credit risks such as interest rate or market risks.

44. **Off-site analysis, anti-money-laundering (AML) measures and inter-agency cooperation should be further strengthened.** Accurate information systems are essential for continuous offsite analysis of banks’ risks, together with a database to provide meaningful comparisons over time and between banks. The NBS should issue a “know your customer” regulation and ensure that AML issues are covered in its on-site inspections. NBS should also establish a formal system of exchange of information and cooperation with all other relevant domestic agencies, including the MOF.

**Framework for Crisis Management**

45. **The design of emergency-lending facilities is generally sound, but could be improved.** The authorities have acquired credibility in closing weak banks, particularly the top four banks closed in 2002. However, the new Lender of Last Resort (LOLR) facility may worsen moral hazard by banks and increase political pressure on the NBS to intervene, as trigger procedures for intervention are not clearly defined. The LOLR interest rate structure also sends inappropriate signals, with the longer-term facility, designed primarily for insolvent banks, carrying a lower rate than the short-term facilities.
46. **Euroization can constrain the LOLR functions.** In April 2005, gross foreign exchange reserves amounted to US$4.5 billion, while the deposit base was US$3 billion, of which US$1.2 billion held at the NBS as required reserves. Thus, gross foreign exchange reserves can cover a deposit run of the remaining free deposits in the amount of US$1.8 billion. However, a sudden drawdown of foreign exchange reserves in the face of a bank run could potentially erode confidence in the exchange rate regime, contributing to a scenario in which banking sector and exchange rate crises interact.

47. **The team proposed three specific measures to strengthen the safety net.** First, provide assistance to illiquid banks based on a single, fully collateralized facility with an interest rate that is a multiple of the policy rate. Second, introduce a penalty for repeated use by making the interest rate rise according to the frequency of access by a bank within a certain period. Third, any bank that repeatedly accesses the LOLR window, indicating a solvency problem, should be subject to resolution by BRA.

48. **In reviewing the deposit insurance scheme (DIS), the institutional capacity of the BRA and the size of the deposit insurance fund are key issues.** The new DIS Law approved on July 15, 2005 allows €3,000 coverage for household deposits only, targeting 98 percent of household depositors and 23 percent of household deposits. Moral hazard concerns are limited, since the scheme is to protect small depositors, and would prohibit liquidity support to distressed banks. The size of the fund is presently limited, although €22 million will be lent by donors as seed capital. However the BRA may be overstretched, and the collection of premiums will be suspended when the fund reaches 5 percent of total deposits. The team recommended that the authorities be given the discretion to require the collection of premiums to continue, even after the level of the fund reaches the 5 percent threshold, based on an assessment of the overall soundness of the banking system when the threshold is achieved.

**DEVELOPMENT ISSUES**

**Banking Privatization and Governance**

49. **The rapid growth of the banking sector from a small base and the lack of non-bank financing alternatives means that credit growth can be expected to continue at a high level, and banks – mainly foreign – will remain the main source for financing economic growth.** The process of bank privatization is accelerating which will increase the share of foreign banks still further. With the notable exception of the third largest bank in the country (KB), most existing majority-owned state banks and several minority stakes held are to be divested in 2006. However, since some banks may not attract an acceptable buyer, consideration should be given to alternative resolution strategies.

50. **Bank governance is still weak, although banks are required to comply with the 2004 Company Law which introduced a corporate governance framework broadly in line with international practice.** Internal and external audit provisions for banks should be expanded. Banks should be required to establish audit committees, with a majority of independent directors, and to establish credit and other relevant board subcommittees. Banks should be required to inform the NBS about the statutory auditor they have selected, and the NBS should have the power to veto such appointments. The NBS should be required to establish a list of acceptable auditors. Audited IFRS financial statements – including auditor’s
report, balance sheet, income statement, cash flows, statement of changes in equity, and notes—should be filed with the Solvency Center, placed on a bank’s web site, and be available from the bank upon request by interested users.

Insurance and Pensions

51. **In the short term, growth in the insurance industry is likely to be limited by several impediments.** Current restrictions state that all reinsurance must be placed with domestic firms, discouraging global insurers. Viable firms are prevented from gaining market share by the non-commercial operation of the two dominant insurers. Multi-level selling of life insurance by several companies should be discouraged. In addition, some insurers avoid paying motor claims, reflecting the high transaction costs of resorting to the legal system. The recent closure of 18 companies will crystallize many claims that may not otherwise have been acknowledged, because claimants will have recourse against guarantee arrangements once wind-up procedures have been completed. This will require special transitional funding arrangements to be designed, approved, and implemented.

52. **Under the 2004 Insurance Law, supervision was transferred to the NBS and an Insurance Supervision Department created.** Under an experienced bank supervisor, the department has begun an impressive work program. This includes the closure of 15 insurers between November 2004 and February 2005 which has highlighted deficiencies in the regime for insurance bankruptcy and liquidation, for which responsibility has been passed to the BRA. Recruiting and training the new supervisory staff is underway, but actuarial and off-site inspection skills are in short supply.

53. **The two large state insurers are slated for privatization for which DDOR appears to be better suited in the near term.** The NBS has requested that both insurers prepare business plans prior to full on-site inspections. Assistance will be needed to develop restructuring plans. A tender for a privatization advisor can only be launched by the BRA after the approval of the respective legislation.

54. **Voluntary pensions are written through licensed life insurers subject to an additional minimum capital requirement of €1 million.** However, prudential standards are inadequate because matching assets are not segregated from insurance assets. The applicable tax policy is also ad hoc. A new law on voluntary pensions should be finalized and implemented.

Capital Markets

55. **The Serbian financial system faces several developmental challenges relating to limited access to finance by the corporate sector in the absence of capital market depth.** The absence of corporate bonds and commercial paper combined with inadequate access to equity markets exacerbates dependence on bank financing, prevents the corporate sector from hedging against exchange rate depreciation and results in excessive vulnerability of the economy to corporate sector stress. The authorities have initiated several reforms to modernize the regulatory and institutional framework.
Leasing

56. **Leasing grew fast in 2004 and has become an important source of long-term financing for SMEs.** Banks typically consider lending to SMEs, farmers and startup businesses to be risky owing to the lack of proper collateral, credit history and high transaction costs. A lease allows a lessor to address such risks through ownership of the asset, lower costs and flexibility in tailoring lease payments to the cash flow of a lessee. However, recent changes in the tax treatment of financial leasing (under the VAT Law and Corporate Income Tax) have removed its competitive advantage, since VAT must be paid up front on the entire interest and fee element of a leasing contract, whereas interest and fees on bank loans do not bear VAT. Future development will also depend upon a level playing field for investment promotion. Lessees are presently not allowed any income tax credit for fixed assets acquired through financial leasing, unlike for assets purchased with own funds and from the proceeds of bank loans.

57. **On July 15, 2005 the parliament approved amendments to the Law on Financial Leasing which empower the NBS to license and supervise financial leasing companies.** The objective, as explained by the NBS, is to restrain the spillover from bank lending into leasing transactions that might circumvent prudential regulations on banks. This understandable concern arises because most Serbian leasing companies are associated with banks, for which leasing is essentially a credit substitute. The team supports supervision of financial leasing by the NBS, providing that control is exercised lightly.

Monetary Policy and Payments

58. **The main monetary policy instrument for discrete changes in the policy stance has been through changes in statutory reserve requirements (SRR), but repo operations were recently introduced.** The effective SRR are changed relatively often and, as of mid-August 2005, stood at 45 percent for foreign currency deposits of households, 29 percent for all other foreign currency deposits, and 21 percent for SRD deposits. To address foreign exchange pressures, SRRs were complemented in June 2004 by the requirement that each and every day banks maintain with the NBS at least 80 percent of the SRR. However this minimum daily requirement is an impediment to money market development as it reduces liquidity and trading opportunities. Recognizing the inadequacies of the reliance on SRR, in January 2005 the NBS introduced weekly repo auctions, collateralized by government bonds.

59. **There is much scope to strengthen monetary policy transmission by deepening money markets.** The first recommendation is to lower the 80 percent daily minimum requirement for SRR. The NBS should also encourage two-way repo operations by injecting liquidity through very short-term repos. The increase in the SRR and the removal of remuneration on foreign currency deposits should encourage greater use of dinars and increase the responsiveness of lending rates to changes in policy interest rates, but the design of the interest rate corridor should be reviewed. NBS deposit rates, Lombard rates, and the discount rate should be modified to be more responsive to market conditions. Monetary instruments might be rendered more effective if the NBS were to engage in further analytical work on monetary transmission and pass-through variables.
60. The MFP Transparency Assessment notes that policy effectiveness would gain from greater public disclosure of broad objectives and intermediate targets. The public information services of the NBS rely on published material, electronic updates and verbal communication, but the availability of information is undermined by poor consistency with statistical standards.

61. While the institutional framework establishes the broad modalities for monetary-fiscal coordination, operational demarcations are somewhat unclear which at times complicates monetary operations. In part this stems from the reluctance of the MOF to increase its reliance on T-bills for financing the budget deficit, and political resistance to raising monetary policy interest rates to the extent needed to mop up excess liquidity. Weak coordination between the NBS and the Treasury in the areas of liquidity forecasts and the issuance of T-bills also complicates monetary operations.

62. Payment systems have been subject to major reform in recent years and since January 2003 Serbia has enjoyed a modern infrastructure for the handling of interbank payment transactions. While large-value and time-sensitive payments are settled in central bank money in the NBS real-time gross settlement (RTGS) system, which is systemically important, retail payments are processed in the NBS Clearing system, with multilateral net positions settled three times a day in the RTGS system. Securities settlement and delivery of collateral in central bank operations takes place in the Central Securities Depository and Clearing House of Serbia (CSDCHS). The RTGS system has proved to be a very reliable and well functioning system, compliant with the Core Principles for Systemically Important Payment Systems (CPSIPS) and highly regarded by its participants.

Corporate sector

63. A new regime for the establishment and operation of companies and related corporate entities entered into force in November 2004 based largely on EU and international practice. The new Law on Business Companies represents a significant improvement over the previous law. The provisions governing limited liability companies have been simplified and joint stock companies may now be either open or closed. The latter have no capital maintenance requirements and may impose restrictions on the transfer of their shares. Most importantly, the new law introduced improvements to the provisions dealing with corporate governance, mergers, conversion from one corporate form to another, disclosure requirements and company liquidation outside bankruptcy. An amendment will still be required to remove some inconsistencies and conflicts with the securities and other legislation.

64. However the legal and regulatory framework leaves open substantial opportunities for corporate governance abuses. Weaknesses are low transparency of ownership, financial reporting and board activities. Issues also remain regarding protection of shareholders in the event of capital dilution and corporate takeovers. The securities regulator suffers from insufficient legal authority and weak institutional capacity. Investment funds remain unregulated and pose a risk for future private pension funds. Compared to the corporate sector, governance of banking is relatively strong, but the NBS requires additional statutory authority to provide adequate supervision.
65. **Procedures for the registration of new companies and filing of company documents have been much improved following the entry into force of the Law on Business Registry in January 2005.** Registration of companies, formerly handled by the courts, can now be done within days rather than weeks. Operation of the Registry has been handicapped by IT and other problems, but the new system is already regarded as a success by its users. The Registry is expected to be self-financing and its scope is to be expanded to handle the registration of pledges over movable property and financial leases.

**Auditing and financial reporting**

66. **Financial information to improve risk assessment is becoming available through the NBS Solvency Center and the Credit Bureau established by the Bankers' Association.** The Solvency Center runs a registry to which all legal entities (113,000) are required to send financial statements and corporate information. The Credit Bureau, on the other hand, collects information on the liabilities, credit and transaction accounts of individuals (three million) from all commercial banks in the system. Both agencies would be strengthened by access to credit information from leasing companies, insurance companies and savings and credit cooperatives.

67. **A potentially serious shortage of auditors exists, because the MOF has not issued any professional certificates since early 2003 for the approval of auditors.** The Accounting and Auditing Law of 2002 required the Federal Government to establish an Auditing Commission to assume supervision on behalf of the MOF and envisaged that registered professionals would be required to complete certification examinations in IFRS within three years. However the Federal Government did not establish the Commission, so new certification is not occurring. The Serbian MOF is preparing a new draft law on accounting and auditing, which will address the licensing of statutory auditors.

68. **Financial reporting standards for companies and banks are presently in transition from compliance with national standards to compliance with international standards, but important discrepancies remain.** The Accounting and Auditing Law of 2002 required banks to comply with IFRS for the end-2003 financial statements. All other enterprises, including sole traders, were required to comply with IFRS as from end-2004, an unduly onerous requirement for small companies and micro-enterprises. Within the banking community, it is recognized that bank financial statements for 2003 did not comply with IFRS, and that those for 2004 will show discrepancies. Notes to the financial statements include full details of where the Serbian accounting policies employed differ from IFRS.

**Bankruptcy**

69. **Serbia introduced a modern and comprehensive Law on Bankruptcy Procedure in July 2004 which provides greatly streamlined procedures for bankruptcy and will permit improved debtor-creditor solutions to develop.** The law is consistent with the practices of other countries that have recently modernized their bankruptcy frameworks and with the World Bank Principles on Creditor Rights Systems. Unfortunately, the new Law on Bankruptcy Procedures will only come into effect after the Law on Bankruptcy Trustees also becomes effective. In the interim, bankruptcies are continuing to be handled under the old, unsatisfactory law.
70. A new regime governing the bankruptcy and liquidation of banks and insurers is contained in a draft law recently submitted to the Assembly, but the draft lacks the precision required. Of particular concern are provisions dealing with the consequences of an NBS decision to revoke a license. The draft and the current law both require the NBS to initiate liquidation proceedings immediately in the Commercial Court, but the licensee has the right under the banking law to have the decision of the NBS reviewed by the Supreme Court. As recent events have indicated, the decisions of these two courts may be incompatible. Preferably the actions of the NBS in revoking a banking license and the consequences of those decisions should be subject to review by a single judicial authority.

Property and Land

71. A modern Law on Pledges on Movable Property was introduced in 2003. The new law incorporated EU norms, but could not become effective because of delays in establishing the Pledge Registry. A recent amendment to the Law on Business Registers Agency has enabled the Pledge Registry to become operational as from July 1, 2005. Pledgors will be given 90 days to register and acquire priority rights to their existing pledges.

72. Available land for investment purposes is scarce because most land is still in state ownership and cannot easily be acquired. For such land only a right of use can be obtained from the state. A draft Land Law addresses many of the problems related to land reform but it will be some time before mortgages over real estate become common. The situation is complicated by the existence of three parallel systems for evidencing property rights over land: (i) the Land Register held by the Municipal Courts based on the Austro-Hungarian system; (ii) the Tappi system held by the District Courts based on the Ottoman system; and (iii) the Cadastre held by the Geodetical Institute of Serbia. These registries are unconnected and not all land is contained within them. A new country-wide land registry based on the Cadastre is being introduced but this will take considerable time to implement.

The Court System

73. There is general agreement that the court system does not function well and that the administration of justice is slow, inefficient and in need of reform. Notably the weak judiciary precludes the prompt recovery of collateral, undermining the ability of the banks to lower their NPLs. Lack of respect for judges and the rule of law have resulted in the courts being perceived as a last resort. The authorities are well aware of the weaknesses in the court system and have begun to take appropriate measures. External help has been obtained to promote reform in the Commercial Court including training and IT support. The government is developing a comprehensive Strategy for Judicial Reform to regain the trust of citizens in their judicial institutions and to assist the ministry of justice and the judiciary to carry out the much-needed reforms. A new Law on Enforcement Procedure has just been enacted which has improved the ability of creditors to enforce judgments and recover collateral.
### ANNEX. Summary Table of Recommendations

<table>
<thead>
<tr>
<th>Recommended Measures</th>
<th>Entity</th>
<th>Status of Implementation</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Banks and Banking Supervision</strong></td>
<td>NBS</td>
<td>Included in the Banking Supervision Action Plan agreed with the World Bank 1/ and in the Memorandum on Economic and Financial Policies (MEFP) submitted to the IMF 2/</td>
</tr>
<tr>
<td><strong>Short term</strong></td>
<td>NBS</td>
<td>Included in the <strong>new</strong> banking law detailed in the MEFP 3/</td>
</tr>
<tr>
<td>Adopt a time bound corrective action plan to address deficiencies in compliance with Basel Core Principles.</td>
<td>NBS</td>
<td>Amendments to the regulations governing reporting requirements made in May 2005.</td>
</tr>
<tr>
<td>Ensure banks provide the NBS with accurate asset classifications on their loans.</td>
<td>NBS</td>
<td>Done in NBS Decision.</td>
</tr>
<tr>
<td>Expand NBS data gathering capabilities to capture all foreign currency and foreign currency indexed loans.</td>
<td>NBS</td>
<td>NBS aims to implement this measure and - for all banks examined - to ensure the timely adoption of the resulting recommendations (MEFP).</td>
</tr>
<tr>
<td>Require banks to monitor and assess borrowers’ exposure to exchange rate risk and to reflect their assessment in the loan classification.</td>
<td>NBS</td>
<td>Included in the <strong>new</strong> banking law detailed in the MEFP.</td>
</tr>
<tr>
<td>Revise criteria for loan loss provisions to minimize the number of reductions in the required provisions that are allowed on the basis of guarantees and/or tangible collateral held.</td>
<td>NBS</td>
<td>Included in the <strong>new</strong> banking law detailed in the MEFP.</td>
</tr>
<tr>
<td>Undertake full-scope examination of the largest state banks and ensure that recommendations arising from examinations are adopted.</td>
<td>NBS</td>
<td>Included in the <strong>new</strong> banking law detailed in the MEFP.</td>
</tr>
<tr>
<td>Bring forward the privatization agenda for the two large state-controlled banks.</td>
<td>MOF/BRA</td>
<td>Included in MEFP.</td>
</tr>
<tr>
<td><strong>Long term</strong></td>
<td>MOF/BRA</td>
<td>Included in MEFP.</td>
</tr>
<tr>
<td>Strengthen all state-controlled banks’ reporting requirements.</td>
<td>MOF/BRA</td>
<td>Included in MEFP.</td>
</tr>
<tr>
<td>Revise NBS chart of accounts to conform to IFRS.</td>
<td>NBS</td>
<td>Included in the <strong>new</strong> banking law detailed in the MEFP.</td>
</tr>
<tr>
<td>Require bank boards to have audit committees comprising a majority of independent members.</td>
<td>NBS</td>
<td>Included in the <strong>new</strong> banking law detailed in the MEFP.</td>
</tr>
<tr>
<td>Require banks to disclose to borrowers the effects of foreign exchange fluctuations on their debt service costs.</td>
<td>NBS</td>
<td>Included in the <strong>new</strong> banking law detailed in the MEFP.</td>
</tr>
<tr>
<td>Enforce the limits for exposure to large borrowers, and for exposure to individual connected parties, with respect to all banks, especially state-controlled banks.</td>
<td>NBS</td>
<td>Included in the <strong>new</strong> banking law detailed in the MEFP.</td>
</tr>
<tr>
<td>Require that all state banks’ directors are subject to NBS “fit and proper” criteria.</td>
<td>NBS</td>
<td>Included in the <strong>new</strong> banking law detailed in the MEFP.</td>
</tr>
<tr>
<td><strong>Recommended Measures</strong></td>
<td><strong>Entity</strong></td>
<td><strong>Status of Implementation</strong></td>
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<tr>
<td>Amend banking law to authorize the NBS to supervise banks on a consolidated basis.</td>
<td>NBS</td>
<td>Included in the new banking law detailed in the MEFP.</td>
</tr>
<tr>
<td>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 over a bank.</td>
<td>NBS</td>
<td>Included in the new banking law detailed in the MEFP.</td>
</tr>
<tr>
<td>Seek explicit statutory protection for the NBS, its officers and staff when performing banking supervision in good faith in accordance with the law.</td>
<td>NBS</td>
<td>Included in the new banking law detailed in the MEFP.</td>
</tr>
<tr>
<td>Establish limits for a bank’s aggregate exposures to related parties, preferably below the EU maximum of 20 percent of capital...</td>
<td>NBS</td>
<td>Included in the new banking law detailed in the MEFP.</td>
</tr>
<tr>
<td>Require bank boards of directors to accept responsibility for establishing and overseeing integrated risk management systems.</td>
<td>NBS</td>
<td>Measure empowering the NBS to apply remedial actions in the event of financial misreporting included in the new banking law detailed in the MEFP.</td>
</tr>
<tr>
<td>Include IT specialists within the NBS examinations staff.</td>
<td>NBS</td>
<td>Procedural and staff enhancements started recently.</td>
</tr>
<tr>
<td>Define the powers of the courts in the Banking Law to review the substantive or technical decisions of NBS.</td>
<td>MOJ/NBS</td>
<td>To be considered for inclusion in the new banking law.</td>
</tr>
<tr>
<td>Increase further the statutory reserve requirement (SRR) ratio on enterprises’ foreign-currency deposits and commercial banks’ foreign borrowing.</td>
<td>NBS</td>
<td>On June 10, the SRR on enterprises’ foreign currency deposits and on commercial banks’ foreign borrowing was raised by 5 percentage points to 26 percent and the SRR on dinar deposits was reduced by 1 percentage point to 20 percent.</td>
</tr>
</tbody>
</table>

**Monetary Policy**

- Introduce a single, fully collateralized lender of last resort facility priced at a multiple of the market rate.

- Lower the daily minimum requirement of 80 percent of the SRR.

- Link the ceiling and the floor of the interest rate corridor with market conditions.

- Initiate the process of participation of Serbia in the GDDS.

**Financial sector development**

- Increase transparency of ownership and control of traded companies.

- Require publication of the full IFRS audit report, supporting schedules and auditor’s opinion.
<table>
<thead>
<tr>
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<th><strong>Status of Implementation</strong></th>
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</thead>
<tbody>
<tr>
<td>Strengthen the responsibility and accountability of supervisory boards.</td>
<td>SC/MOF</td>
<td></td>
</tr>
<tr>
<td>Increase shareholder protection during capital increase and takeovers.</td>
<td>MOF</td>
<td></td>
</tr>
<tr>
<td>Ensure IFRS and NBS accounting rules are fully applied to insurance company fixed assets and accounts receivable.</td>
<td>NBS</td>
<td>Included in MEFP.</td>
</tr>
<tr>
<td>Commence NBS on-site examinations at the two large state insurers (DDOR and Dunav).</td>
<td>NBS</td>
<td>Included in MEFP.</td>
</tr>
<tr>
<td>Require DDOR and Dunav each to submit their business plans and appoint financial advisors to develop and execute a privatization strategy.</td>
<td>NBS</td>
<td>Privatization of DDOR included in MEFP.</td>
</tr>
<tr>
<td>Develop a strategy for funding Third Party Liability Insurance under the guarantee arrangement.</td>
<td>NBS</td>
<td></td>
</tr>
<tr>
<td>Phase out restrictive trade practices regarding mandatory reinsurance cessions and long-term property insurance contracts.</td>
<td>NBS</td>
<td></td>
</tr>
<tr>
<td>Implement the corrective action plan for AML/CFT recommendations put forward in MONEYVAL report.</td>
<td>APML</td>
<td></td>
</tr>
<tr>
<td>Strengthen the SC's legal authority and institutional capacity.</td>
<td>SC</td>
<td></td>
</tr>
<tr>
<td>Develop regulatory framework for investment funds in line with EU Directives and international practice.</td>
<td>SC</td>
<td></td>
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<tr>
<td>Finalize and implement the law on voluntary pensions.</td>
<td>MOF</td>
<td></td>
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<tr>
<td>Constitute the MOF Commission to adopt certified auditors and accountants.</td>
<td>MOF</td>
<td></td>
</tr>
<tr>
<td>Modify accounting and auditing legislation and regulations to enable the implementation of the policy recommendations set out in the Accounting and Auditing ROSC.</td>
<td>MOF/NBS</td>
<td></td>
</tr>
</tbody>
</table>

1/ Several of the proposed measures in this Summary of Recommendations will likely be incorporated in the conditionality for the Programmatic Private and Financial Development Policy Loan 1 (PPFDPL-1) presently under preparation by the World Bank. The key measures for addressing shortcomings in banking supervision are contained in a Banking Supervision Plan already agreed in principle by the NBS with the World Bank.

2/ The MEFP was prepared as part of the Fifth Review under the Extended Arrangement (EA) which was concluded by the Executive Board of the IMF on June 29, 2005.

3/ Under the EA, the parliamentary approval of the new banking law in line with the recommendations of the FSAP team is a structural performance criterion for mid-November 2005.