May 2010
IMF Country Report No. 10/148

Republic of Serbia: Financial Sector Assessment Program Update—Detailed Assessment of Basel Core Principles for Effective Banking Supervision

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

The policy of publication of staff reports and other documents by the IMF allows for the deletion of market-sensitive information.

Copies of this report are available to the public from

International Monetary Fund ● Publication Services
700 19th Street, N.W. ● Washington, D.C. 20431
Telephone: (202) 623 7430 ● Telefax: (202) 623 7201
E-mail: publications@imf.org ● Internet: http://www.imf.org

International Monetary Fund
Washington, D.C.

FINANCIAL SECTOR ASSESSMENT PROGRAM UPDATE

REPUBLIC OF SERBIA

BASEL CORE PRINCIPLES FOR EFFECTIVE BANKING SUPERVISION

DETAILED ASSESSMENT

MARCH 2010

INTERNATIONAL MONETARY FUND
MONETARY AND CAPITAL MARKETS DEPARTMENT

THE WORLD BANK
FINANCIAL AND PRIVATE SECTOR DEVELOPMENT VICE PRESIDENCY
EUROPE & CENTRAL ASIA REGION VICE PRESIDENCY

FINANCIAL SECTOR ASSESSMENT PROGRAM

ASSESSMENT OF COMPLIANCE WITH THE BASEL CORE PRINCIPLES FOR EFFECTIVE BANKING SUPERVISION

Tables

I. Summary, Key Findings, and Recommendations

Introduction

1. This assessment of the Basel Core Principles (BCP) was conducted as part of the Financial Sector Assessment Program (FSAP) updated evaluation of the Serbia financial system from October 6 to October 21, 2009. The supervisory framework was assessed against the BCP methodology issued in October 2006. The assessment was conducted by Mr. Miquel Dijkman, World Bank staff, and Mr. Fernand Naert, a consultant with the IMF and former CBFA staff.

Information and Methodology used for Assessment

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

3. The assessment of compliance with each principle is made on a qualitative basis. A four-part assessment system is used: compliant; largely compliant; materially non-compliant; and non-compliant. To achieve a "compliant" assessment with a principle, all essential criteria generally must be met without any significant deficiencies. A "largely compliant" assessment is given if only minor shortcomings are observed, and these are not seen as sufficient to raise serious doubts about the authority's ability to achieve the objective of that principle. A "materially non-compliant" assessment is given when the shortcomings are sufficient to raise doubts about the authority's ability to achieve compliance, but substantive progress has been made. A 'non-compliant' assessment is given when no substantive progress toward compliance has been achieved.

4. The ratings assigned during this assessment are not comparable to the ones assigned in the 2005 FSAP, as the bar to measure the effectiveness of a supervisory framework has been raised in the new methodology. New criteria have also been added while existing ones have been redefined following the revision of the methodology in October 2006.

Institutional and Macroeconomic Setting and Market Structure-Overview

5. The Serbian financial sector is dominated by the banking industry, which accounts for 89 percent of the financial sector assets. Total financial assets amount to 71 percent of GDP. Currently 34 banks operate in Serbia. They are represented by 8 state-controlled banks (representing 15 percent of total financial sector assets), 6 local private banks (8 percent of total financial sector assets) and 20 foreign-owned banks (66 percent of total financial sector assets). The NBS is responsible for licensing, regulation and supervision of the aforementioned banks, hereinafter called "scheduled banks". The NBS is also responsible for the supervision of insurance companies, voluntary pension funds and leasing companies. Although nonbank financial institutions (NBFIs) have been growing apace, they remain small with assets representing 11% of the banking sector.

6. Following the complete overhaul of the financial system in the early transition years, the NBS has undertaken major efforts to upgrade the legal and regulatory framework for banking supervision. The 2005 Law on Banks (LOB) envisaged harmonization of the legal framework with international standards, European Union (EU) Directives and the BCPs on banking supervision. The NBS also has enhanced risk management standards in the banking sector by issuing new regulation. Banks are now required to set up risk management systems, including risk identification, measurement, assessment and mitigation taking into account the scope, type, and complexity of their operations. Furthermore, the NBS issued specific rules on a large number of aspects of banking operations, including liquidity risk management, capital adequacy requirements, loan classification and provisioning, external auditing and know-your-customer procedures. Mirroring increasing foreign ownership in the Serbian banking sector, the NBS also intensified cooperation with foreign supervisors, although cooperation still needs to be formalized in the form of bilateral Memoranda of Understanding (MOU) with a number of important home supervisors.

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

Partly reflecting high solvency buffers, profitability in the Serbian banking system was typically low by regional standards. By 2009H1, the average return on equity (ROE) amounted to 4.1 percent, compared to 9.3 percent in 2008.

8. The global financial turmoil began to spill over to Serbia in the late 2008. The turmoil manifested itself initially in the form of a sharp deterioration in the financial outlook, including sharp corrections in the stock market, rising sovereign spreads, slowing capital inflows and—amid high volatility and frequent NBS interventions—a depreciation of the dinar. Following false rumors about an impending banking crisis, households withdrew some of their foreign-currency denominated deposits. Credit growth came to a sudden halt and the economy went into a recession.

9. Although the Serbian banking sector entered the crisis with reassuring solvency and liquidity buffers, these developments signaled increasing financial stability risks. The deteriorated economic outlook has strongly affected the corporate sector's financial condition, as illustrated by a sharp increase in non-performing assets. Households' balance sheets were hit by a combination of rising unemployment and the depreciation of the dinar. The latter caused financial stress as most households are unhedged borrowers in foreign currency loans. As a result, nonperforming loans (NPLs) increased from 11.3 percent of total loans in 2008 to 16.5 percent in 2009H1. NPLs are more than covered with total provisions.

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

Preconditions for Effective Banking Supervision

11. Prior to the crisis, Serbia posted several years of solid economic growth, which was mainly driven by buoyant domestic demand and was accompanied by increasing external imbalances. The NBS introduced inflation targeting by end-2006 and conducts a managed float of the dinar. This has contributed to a gradual decline in headline inflation figures, currently around 9 percent y-o-y. In the run-up to the crisis, rising fiscal deficits were offset by a booming

economy, causing the public debt ratio to decline. Gross public debt currently stands at around 32 percent of GDP.

12. Serbia currently faces a number of risks to its macroeconomic and financial sector stability, of which are direct relevance to the banking sector. These include inter alia a scenario of prolonged weakness, which could be exacerbated by a slow economic recovery in Serbia's main trading partners. This would further deteriorate asset quality, with a corresponding deterioration of banks' balance sheets. Another key risk is the recurrence of FX market pressures. A depreciating currency is associated with increasing financial stress for unhedged borrowers, primarily households. Although banks have shifted exchange rate risk to the household and real sectors, FX risk would resurface in the form of rising credit risk.

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

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

15. In the context of the financial crisis, several aspects of the crisis management framework were significantly enhanced. Besides the additional liquidity facilities for banks participating in the FSSP (see para 10), the NBS opened LOLR facilities up to one year at 150 percent of the policy rate to solvent banks against selected liquid collateral. In response to the deposit run in late 2008, deposit insurance coverage was raised drastically from EUR 3,000—per private individual depositor per bank to EUR 50,000—while the list of eligible depositors was extended to include sole entrepreneurs and small and medium enterprises (SMEs). Coverage levels are currently very high, as 99 percent of deposits of the banking system by number and 90 percent by volume are covered by the Deposit Insurance Fund (DIF). The DIF's total financial assets currently amount to EUR 98.4 million compared to total insured deposits of EUR 5.4 billion. The funding capacity of the DIF in case of a systemic crisis is limited, and no government contingency funding lines of credit are in place. The DIF is prohibited from using its funds for

bank resolution actions like mergers or sale of selected liabilities and assets. Lastly, a new Banking Stability law, outlining the legal framework for contingency measures to be activated in the event of a systemic crisis is awaiting enactment.

Main Findings

16. Since the previous FSAP, Serbia has made considerable progress towards enhanced compliance with the BCPs and with international standards. A major overhaul of the legal framework—the enactment of the new LOB in 2005—and the issuance of new regulations provided the basis for this improvement, which are reflected upgraded scores for a considerable number of BCPs. By now, Serbia is Compliant or Largely Compliant with most BCPs. Serbia is assessed "compliant" with 9 BCPs, "largely compliant" with 13, and "materially non-compliant" with 8. The assessors are of the view that the outcomes correspond to an overall "largely compliant" score.

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

Objectives, independence, powers, transparency and cooperation (CP1)

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

19. Although the NBS takes a proactive stance with regard to cooperation with foreign supervisors, cooperation with a number of important home supervisors is awaiting formalization in the form of bilateral MOUs. The main impediment is the mandatory exchange of information between the NBS and the national tax authority, which raises confidentiality concerns on behalf of the home authorities.

Licensing and structure (CP 2–5)

20. The new Law on Banks has brought major improvements, notably with regard to the licensing process and the legal framework for transfer of significant ownership. The licensing process is now split up in two stages and the NBS has the authority to withdraw a bank's license

in case conditions that motivated the NBS to grant the license no longer exist. Following the enactment of the new Law on Banks, threshold levels for supervisory approval for transfer of significant ownership have been lowered and are currently in line with best practices. The LOB spells out clear limits as to maximum investments that banks are allowed to undertake. A body of criteria on the basis of which proposed acquisitions of *banks* are assessed is in place, but the framework does not explicitly address the acquisition of non-bank financial institutions.

Prudential regulation and requirements (CPs 6–18)

21. The capital adequacy framework is conservative by regional standards and is broadly aligned with international sound practice. It seems adequate given the current structure of the Serbian banking sector and the nature of its operations. There is however a need to further to upgrade the regulatory framework beyond credit risk. The NBS has started issuing new regulations, which is clearly bearing fruit in some areas (e.g., liquidity risk). Other areas such as market risk, country risk, operational risk and interest rate risk are however still in need of an equivalent upgrading, although new regulation is being prepared as part of Basel II preparations. Even though these risk categories are presently of limited relevance to the Serbian banking sector, upgrading of regulation and supervisory practices in those areas is necessary in a financial system that is likely to expand and to become increasingly complex over the next years. Basel II implementation, scheduled for 2011[1], also makes this an urgent issue.

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

Methods of ongoing banking supervision (CPs 19–21)

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

---

[1] The NBS is currently reviewing the possibility to push back Basel II implementation due to the changes in the international environment and legislation.

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

Accounting and disclosure (CP 22)

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

Corrective and remedial powers of supervisors (CP 23)

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

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

27. The NBS not only supervises banks, but also leasing companies, insurance companies and pension funds, and is therefore in a favorable position to conduct consolidated supervision over banking groups whose controlling entity is established in Serbia. The NBS exerts due diligence with regard to shareholder-structures over banks, their transparency and their potential impact on supervision. Serbian law requires publication of consolidated statements on the basis of standards inspired by international practice. The possibility to exclude minor entities from

consolidation and the very limited impact of subsidiaries on Serbian banks somewhat limits the impact of this requirement. NBS does not systematically analyze consolidated risk position, and supervisory requirements for reporting on a consolidated basis by banks can be improved.

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

Table 1. Summary Compliance with the BCPs-Detailed Assessments

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

2. Permissible activities	C	The term 'bank' is reserved for banks while the range of permitted activities is kept concise.
3. Licensing criteria	C	Introduction of a two-phase licensing process has brought major improvements.
4. Transfer of significant ownership	C	Thresholds for supervisory approval are in line with best practices. The NBS can refuse on various grounds.
5. Major acquisitions	LC	Limits are set on major acquisitions. Reviews are however not conducted on major non-banking acquisitions, limiting the awareness of and ability to mitigate the attendant risks.
6. Capital adequacy	LC	Capital adequacy requirements and risk weights are conservative. There is scope for aligning the capital requirements framework with that of most EU countries.
7. Risk management process	MNC	For risk categories other than credit and liquidity risk management specific regulation is under preparation but not yet available. There is scope for strengthening the role of qualitative assessments in onsite supervision.
8. Credit risk	C	The regulatory framework and supervisory practices seem adequate. Special attention needs to be given to the follow-up on restructured and rescheduled loans for assessing the quality of credit risk management.
9. Problem assets, provisions, and reserves	C	Classification and provisioning rules are prudent, but the qualitative elements and the practice of formulating brackets rather than minimum provisioning levels create scope for differences in interpretation. Loan classification guidance should be made more precise, consistent and transparent.
10. Large exposure limits	C	Reporting requirements currently do not allow the NBS to highlight geographical portfolio concentrations.
11. Exposure to related parties	LC	The NBS's flexible definition of related parties is helpful in deciding on a case-by-case basis whether material linkages exist. Additional guidance as to which parties are considered related parties would however be useful for reporting purposes.
12. Country and transfer risks	MNC	Detailed regulation on country risk is currently not available.

13. Market risks	MNC	The NBS faces the challenge of taking market risk supervision a step further beyond checking compliance of procedures and policies by assessing the specificities of the limits and their appropriateness given the overall characteristics of the institution involved. Scheduled Basel II implementation as of 2011 makes this an urgent issue.
14. Liquidity risk	LC	Regulation on liquidity risk is in place and is broadly adequate. The current regulation does not require banks to take into account the impact of other risks on the bank's overall liquidity strategy.
15. Operational risk	MNC	Specific skills (IT) are currently lacking with onsite teams, impeding effective supervision in these areas. NBS should upgrade its regulation on outsourcing fully up to EU-standards.
16. Interest rate risk in the banking book	MNC	Secondary regulation on IRBB management is currently unavailable. Similarly, there is a need to step up supervision in this area.
17. Internal control and audit	LC	The scope of compliance responsibility should be upgraded to cover all potential compliance events entailing reputational risks for the bank; the existing ad hoc committee with banks' boards (as prescribed by the banking law) can be upgraded to Audit Committees according to international best practice.
18. Abuse of financial services	C	The legal framework for AML/CFT is much-improved and broadly adequate. There is scope for some further tightening with regard to screenings for new staff.
19. Supervisory approach	LC	The analysis on the level of the global banking sector should be enhanced; the NBS is recommended to perform regular and recurrent stress tests
20. Supervisory techniques	LC	The main challenge facing the NBS is to focus towards more qualitative assessments (onsite), as necessitated by Basel II implementation; NBS needs to step up capacity building for this effort as a priority
21. Supervisory reporting	LC	NBS is recommended to enquire into means for enhancing reporting by more systemic certification; it can also consider further alignment of reporting requirements to EU-practice.

22. Accounting and disclosure	LC	For disclosure by banks, the law should be fully aligned with EU-best practices.
23. Corrective and remedial powers of supervisors	LC	Powers appear adequate. The main priorities are the strengthening of cooperation with other involved supervisors – both domestically and internationally – and ensuring that internal procedures do not prevent the NBS from acting speedily and decisively in the face of serious irregularities.
24. Consolidated supervision	MNC	For the future, NBS is recommended to require formal reporting for financial data and risk profiles on a consolidated basis and to build proper tools for analysis.
25. Home-host relationships	MNC	The requirement for the NBS to exchange information with domestic tax authorities needs to be revisited and aligned with European practice; this would enable the NBS to sign MOU's with all significant home supervisors over Serbian banks; the NBS is recommended to maintain its proactive attitude with regard to information exchange and in cooperation with home supervisors.

Aggregate: Compliant (C) – 7, Largely Compliant (LC) – 14, Materially Non-Compliant (MNC) – 9, Non-Compliant (NC) – 0, Not Applicable (N/A) – 0

Recommended Action Plan and Authorities' Response

Recommended action plan

29. As outlined in the preceding sections, the NBS faces a number of challenges, some of which need to be addressed as a matter of high priority. This section outlines the principal areas for reform, while a more detailed recommended action plan is included in Table 2. The following three items are among the most pressing issues:

- *capacity building*: although staffing levels seem broadly adequate given the current stage of financial development salary, capacity building of the Banking Supervisory Department is a priority in view of the expected further development of the financial system and –especially– Basel II implementation scheduled for 2011. Capacity building relates to increasing the headcount, but also to upgrading of supervisory skills. This will require a concerted effort to retain experienced staff. In this context, the NBS needs to pay particular attention to the competitiveness of the compensation packages, training opportunities and career prospects offered to its staff. This is necessary to avoid shortages of staff further down the road, but also to allow for a shift towards risk-based supervision under Basel II.

- *problem assets, provisions and reserves*: the present divergences between NBS' and banks' assessment of asset classifications and the corresponding provisioning levels illustrates the need to significantly streamline the regulation. The qualitative elements of the framework and the practice of formulating brackets rather than minimum provisioning levels creates differences in interpretation between banks and the NBS, with potentially far-reaching implications for provisioning levels. It is therefore recommended that the NBS considers establishing a more precise set of criteria for loan classification and provisioning that is clear, transparent and acceptable to both banks and supervisors.

- *home host relationships*: given the significant participation of EU-banking groups in Serbia, it is essential that the NBS clears the remaining hurdles for concluding the remaining MOU agreements. It is therefore recommended that the present obligations to exchange information with the domestic tax authorities is reconsidered as a matter of priority.

30. In the medium term, the following remedial measures are suggested to the NBS:

- *risk management regulations*: it is recommended that the NBS issues regulation on risk management categories other than credit risk and (more recently) liquidity risk. Although these risk categories are not of great significance within the Serbian banking sector as of today, the NBS should provide the regulatory basis for further development of the sector and its activities. New regulation in the area of market risk, country risk operational risk and interest rate risk is currently under preparation. The NBS should build as much as possible on EU regulation and Basel guidance.

- *supervisory approach and techniques*: NBS's onsite banking department faces the challenge of shifting towards a more risk-based approach, with greater reliance on qualitative assessments. Rather than checking whether policies and procedures are in place, supervision needs to assess whether risk management arrangements are adequate given the overall characteristics (size, complexity, risk profile) of the respective financial institution. This requires further development of the NBS's tools and manuals and an upgrading of supervisory skills to ensure that staff is capable of conducting risk-based supervision. Due to the significant presence of EU banking groups alignment with EU best practice is recommended.

- *consolidated supervision*: although the NBS conducts supervision on a consolidated basis, it needs to develop a framework for prudential reporting on a consolidated basis. It can take reference with EU-developments in this respect.

- *reporting accounting and disclosure*: the NBS should consult with accounting and auditing associations to develop a legal framework for disclosure and conduct of external audits that is in line with EU best practice. In the same effort, NBS should seek to enhance enhanced cooperation with external auditors in order to ensure a more systematic certification of prudential reports, thereby increasing the auditors' contribution to supervision.

Table 2. Recommended action plan to improve compliance with the BCPs

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

Reference Principle	Recommended Action
Country and transfer risks (BCP 12)	The main recommendation is to upgrade the supervisory framework for country risk, by issuing secondary legislation specifying the exact requirements on banks (limits, provisioning levels, etc).
Market risk (BCP 13)	In addition to issuing specific regulation on market risk, the NBS faces the challenge of taking market risk supervision a step further by assessing the specificities of limits and their appropriateness given the overall characteristics of the institution involved.
Liquidity risk (BCP 14)	The current regulation could be enhanced in order to ensure that the impact of other risks is taken into account in the bank's overall liquidity strategy.
Operational risk (BCP 15)	The main priority is to upgrade supervisory skills in the area of operational risk, with skill shortages especially acute in the area of IT.
Interest rate risk in the banking book (BCP 16)	The key recommendation is to provide banks with additional guidance by issuing specific regulation on IRBB.
Internal control and audit (BCP17)	The main recommendation is to broaden the scope of the compliance function to cover all domains where breaches of laws or regulations can expose the bank to reputational risk. The reporting line of internal audit could be enhanced by the requirement to install an audit committee according to international standards.
Abuse of financial services (BCP 18)	Banks should be required to conduct screenings for new staff as standard routine.
Supervisory approach (BCP 19)	The analysis on the level of the banking sector could be enhanced, while the NBS is recommended to conduct regular stress test.
Supervisory techniques (BCP 20)	The main challenge facing onsite supervision is to shift towards qualitative assessments, which in turn require capacity building as a matter of priority.
Supervisory reporting (BCP 21)	The reliability of reporting could be enhanced through more regular certification, which would require cooperation with external auditors. Reporting requirements could be further aligned with EU practices.
Accounting and disclosure (BCP 22)	Disclosure requirements should be enhanced by fully aligning them with EU best practices.

Reference Principle	Recommended Action
Corrective and remedial powers of supervisors (BCP 23)	The main priority is to strengthen cooperation with other supervisors (both domestically and internationally) and ensuring that internal procedures do not prevent the NBS from acting speedily and decisively in the face of serious irregularities.
Consolidated supervision (BCP 24)	Banks should be required to report on a consolidated basis for key financial indicators (e.g. CAR, provisioning, etc).
Home-host relationships (BCP 25)	The main priority is to clear the way for concluding MOUs with Austria, France and Germany. This requires a reconsideration of the mandatory exchange of information with the national tax authority.

Authorities' response

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

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

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

Finally, we would like to emphasize following:

- We are closely observing the most recent developments and changes in the international standards and principles, triggered by the recent financial crisis, and we are aligning our plans and actions with them.
- The priorities in developing regulations and supervisory tools for risk management categories are based on the assessment of their materiality for Serbian banking sector.
- Recognizing the significance of adequate home-host cooperation, the National Bank of Serbia is participating in all initiatives from the host supervisors, and continuously

initiates communication and information sharing. However, this is a two way process and adequate improvement in this area is subject to effort on both sides."

II. Detailed Assessment

Table 3. Detailed Assessment of Compliance with the Basel Core Principles

Principle 1.	**Objectives, autonomy, powers, and resources.** An effective system of banking supervision will have clear responsibilities and objectives for each authority involved in the supervision of banks. Each such authority should possess operational independence, transparent processes, sound governance and adequate resources, and be accountable for the discharge of its duties. A suitable legal framework for banking supervision is also necessary, including provisions relating to authorization of banking establishments and their ongoing supervision; powers to address compliance with laws as well as safety and soundness concerns; and legal protection for supervisors. Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.
Description	Following the previous FSAP, Serbia has made major progress with regard to BCP 1. This largely reflects the enactment of the 2005 Law on Banks, which redressed a number of weaknesses mainly related to legal powers and protection and hence greatly contributed to supervisory empowerment. Nonetheless, a number of areas for attention continue to exist, notably in the area of staffing autonomy, international cooperation and the lack of explicit objectives for supervision.
Principle 1(1).	**Responsibilities and objectives.** An effective system of banking supervision will have clear responsibilities and objectives for each authority involved in the supervision of banks.
Description	The 2005 Law on Banks and the Law on the NBS constitute the primary legal framework and clearly define the NBS's responsibility in the area of banking, insurance, leasing company and voluntary pension funds. The Law on Banks establishes the NBS's authority to conduct supervision and impose remedial actions (Art 9, Law on Banks). It also provides a skeleton of prudential and corporate governance requirements, which are spelled out in greater detail in secondary legislation (NBS "Decisions"). The NBS has not issued official objectives for supervision. Price stability is the primary objective of the NBS, while the secondary objective is to maintain financial stability. In practice, supervision is understood to support the second objective of the NBS, with the NBS performing supervision of safety and soundness and legal compliance of activities of banks (Art 9).
Assessment	*Largely Compliant*
Comments	It is recommended that the NBS is more explicit in this regard, as the identification of overarching objectives provides an anchor for the advancement of future supervisory policies and practices. Common examples of objectives for supervision include depositor protection, or a stable and efficient financial sector.
Principle 1(2).	**Independence, accountability and transparency.** Each such authority should possess operational independence, transparent processes, sound governance and adequate resources, and be accountable for the discharge of its duties.
Description	Following the previous FSAP, the NBS has made major strides in establishing its supervisory authority, both with regard to the sector and to the Government. In the discussions, NBS staff indicated that Government interference in supervisory practices is entirely absent and that the supervisory department enjoys budgetary autonomy. The Supervisory Department currently employs some 100 employees, of who some 20 are engaged in supervision of foreign exchange houses. It can also hire additional staff

	after the NBS's Executive Board clearance. The NBS's Executive Board members can only be removed from office during their term for reasons specified in the Law on NBS (Art 30). Supervision does not have specific reporting requirements vis-à-vis Parliament, but a section on supervision is included in the general NBS reporting to Parliament. Nonetheless, a number of areas for attention still exist. NBS's banking supervision staffing levels seem adequate given the current stage of financial development, although there are staff shortages in a number of specialist areas, notably IT and auditing. Staffing constraints are likely to become more pressing over the next years as the preparation of Basel II implementation requires a shift in emphasis to qualitative assessment of organization, systems, processes, procedures and manuals. It is therefore recommended that the NBS give priority to capacity building for the Banking Supervisory Department, both in quantitative and in qualitative terms. This is necessary in view of the expected future growth and increasing complexity of the Serbian financial sector and the challenges posed by the implementation of international regulations and standards. The capacity of the NBS to attract and retain qualified staff not only depends critically on the competitiveness of its remuneration regime but also on the career prospects that it can offer to its staff. The NBS intends to hire additional staff in 2010. Although the NBS claims that it doesn't experience major difficulties in retaining qualified staff, salary scales typically do not compare well with the private sector. This is exacerbated by a recent mandatory salary cut instigated by the Government in the state organs. Salaries have been lowered by up to 20%. The NBS has protested arguing that it is independent and therefore cannot be considered a state organ. The NBS brought its case to court and is now awaiting court rule.
Assessment	*Largely Compliant*
Comments	In view of the challenges mentioned above it is recommended that the NBS give priority to capacity building for the Banking Supervisory Department, both by increasing the headcount of the Supervisory Department and by investing in staff's skills. For retaining qualified staff it is important that compensation packages are competitive enough, and that the NBS provides sufficient career perspective and training opportunities.
Principle 1(3).	**Legal framework.** A suitable legal framework for banking supervision is also necessary, including provisions relating to authorization of banking establishments and their ongoing supervision.
Description	The Law on Banks (Section 2) singles out the NBS as the sole authority responsible for the granting and withdrawing of banking licenses. It also establishes the NBS's authority to set prudential standards with regard to capital adequacy requirements, risk management and corporate government standards. The requirements are spelled out in detail in the secondary legislation ("Decisions"). This practice allows the NBS to update prudential standards without changing the overall legal framework. It is through the Decisions that the banking laws and regulations are regularly updated and remain relevant to changing industry and regulatory practices. The first step for issuing decisions is the formation of a project team. The supervisory and legal divisions are included in the drafting process, as well as the General Manager of the Banking Supervision. After a review process, draft decisions are submitted to the Vice Governor on Supervision for review. Although the draft decisions are submitted to the sector for comments, a number of commercial banks expressed some concerns about a lack of voice in the design of new regulation. After consultation of the sector, decisions are submitted to the legal department for a final check. The Decisions are enacted after the

	Governor has signed them. The Law on Banks also establishes that banks are subject to general reporting requirements (elaborated in detail in the Decision on Reporting), while it explicitly authorizes the NBS to make ad hoc information requests (Art 102). The NBS has the right to inspect business books and other documentation of legal entities which are related by proprietary, management and business relationships to the bank which is subject to supervision, and it may also request from these entities to submit other information.
Assessment	*Compliant*
Comments	
Principle 1(4).	**Legal powers.** A suitable legal framework for banking supervision is also necessary, including powers to address compliance with laws as well as safety and soundness concerns.
Description	The Law on Banks enables the supervisor to address compliance with regulations and the safety and soundness of the banks under its supervision. Art 112 allows the NBS to impose remedial actions if the provisions of the Law on Banks, the NBS's regulations or standards of prudent banking activities are not complied with or if a bank is involved in behavior that jeopardizes its safety and soundness. The latter provision allows the NBS to exercise qualitative judgment in ensuring the safety and soundness of the banks in its jurisdiction. The NBS may also impose fines to a bank, a member of the board of directors or a member of the executive board of a bank. NBS staff indicated that qualitative judgment has gained importance in supervisory practice over the past years, reflecting a transition from compliance-based to risk-based supervision. Art 102 ensures the NBS's access to information while Art 104 of the Law on Banks authorizes the NBS to communicate directly with managers and employees of the bank. The NBS's toolkit for remedial actions currently consists of written warnings; ordering letter; orders; receivership and-ultimately-revocation of operating licenses. The framework is in the process of being enhanced (see principle 23).
Assessment	*Compliant*
Comments	
Principle 1(5).	**Legal protection.** A suitable legal framework for banking supervision is also necessary, including legal protection for supervisors.
Description	Article 121 of the Law on Banks provides legal protection to the NBS and its employees. It states that the employees of the NBS and its executive board members shall not be held responsible for damage that arises by the execution of their duties, unless it has been proven that such damage was caused intentionally or by extreme negligence. The legal protection stays in place after termination of employment in the NBS. The article also stipules that the NBS reimburses the expenses of representation of its employees in court and administrative proceedings NBS staff explained that following the enactment of the 2005 Law on Banks no lawsuits against NBS supervisory staff for actions while performing their duties have occurred. The law suggests that financial compensation for legal representation is provided ex post. Although the NBS has not had practical experience, NBS staff indicated that rather than compensating ex post, the NBS is likely to pay upfront. A particular area for attention is the legal protection of receivers that in bank resolution situations act on the NBS's behalf. Currently, the legal framework does not provide separate legal coverage to receivers, although the receivers operate under the general umbrella of the NBS. The fact that the new Banking Stability Law considerably broadens the powers for receivers highlights the importance that their legal protection is addressed in a timely manner.

Assessment	*Largely compliant*
Comments	It is recommended that the next amendments of the Law on Banks specify that the NBS will pay upfront for the legal representation costs for its staff. Legal protection to receivers needs to be enhanced.
Principle 1(6).	**Cooperation.** Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.
Description	Article 65 of the Law on NBS obliges the NBS to cooperate with foreign institutions responsible for banking supervision and domestic bodies and institutions responsible for supervision in the field of financial transactions. Domestically, the NBS has agreements with the administration for AML prevention, the bankers association, the Deposit Insurance Agency (DIA), the tax administration authority, the securities commission, the Belgrade Stock Exchange and the commission for protection of competitions. The MoF, NBS and DIA have concluded a national MOU. The NBS has concluded a great number of regional and bilateral MOU with foreign supervisors, mostly following a standard EU template (see principle 25), encompassing primarily the exchange of information. Joint inspections of Serbian subsidiaries occur and the NBS participates in a number of supervisory colleges. The NBS's experience with the exchange of information with home supervisors is mostly positive, although in a number of cases home supervisors could be more forthcoming. The NBS takes a proactive stance with regard to international cooperation. It participates in a number of supervisory colleges and conducts joint inspections with foreign supervisors. It has also established many bilateral MOUs, but agreements have not yet been reached with a number of important home countries (including Austria, France and Germany). According to NBS staff, the mandatory exchange of information between the NBS and the national tax authority raises confidentiality concerns on behalf of the home authorities. The NBS is home supervisor for only one bank (Komercijalna Bank) with foreign operations. Although MOUs have been concluded with the relevant host authorities, the NBS has taken limited steps to foster cooperation with the foreign supervisors.
Assessment	*Materially non-compliant*
Comments	The obligation for the NBS to exchange information with the national tax authority needs to be revisited for the NBS to formalize its cooperation with the three remaining home country supervisors. An additional advantage is that this will likely promote banks' willingness to share information with NBS staff.
Principle 2.	**Permissible activities.** The permissible activities of institutions that are licensed and subject to supervision as banks must be clearly defined and the use of the word "bank" in names should be controlled as far as possible.
Description	The term "bank" is clearly defined in the Law on Banks. It refers to a joint stock company headquartered in the Republic of Serbia, with the operating license granted by the National Bank of Serbia, which performs deposit and credit activities. Art 4 subsequently describes the range of activities that banks may undertake, while Art 5 specifies the range of activities that may only be performed by banks (i.e. deposit taking, granting credits and issuing payment cards). Art 6 obliges the usage of the word "bank" for companies involved in banking operations, while the usage of the word "bank" and its derivatives is explicitly prohibited for non-bank institutions.
Assessment	*Compliant*
Comments	

Principle 3.	**Licensing criteria.** The licensing authority must have the power to set criteria and reject applications for establishments that do not meet the standards set. The licensing process, at a minimum, should consist of an assessment of the ownership structure and governance of the bank and its wider group, including the fitness and propriety of Board members and senior management, its strategic and operating plan, internal controls and risk management, and its projected financial condition, including its capital base. Where the proposed owner or parent organization is a foreign bank, the prior consent of its home country supervisor should be obtained.
Description	Following up on the recommendations of the previous FSAP, the Serbian authorities have used the revision of the Law on Banks to strengthen the licensing process and to split the procedure in two stages. The procedures are spelled out in Article 15-18 of the Law on Banks. Before granting preliminary approval, the bank is to provide the NBS with a detailed business plan, including a statement of the owner that capital will be paid in, proof that the effective shareholders have stable sources of income, details of the proposed executive board and the board of directors (as part of a fit and proper check), a business plan spanning the first three year of operation, a risk management plan and home supervisory approval (if applicable). The NBS may reject the proposal on various grounds (Art 16); for example, if it is not in compliance with prudential regulation, if it deems the proposed board members or directors unfit or if it judges that the proposed structure does not allow for effective supervision. An operating license is issued following the issuance of the preliminary approval and filing of the request for issuing of this license. The NBS requires proof that capital is effectively paid in, expenses are incurred and that staffing, external auditing and housing requirements are met. After starting operations, the bank is required to assess regularly whether the projections in the business plan are met. Article 130 of the Law on Banks enables the NBS to withdraw a bank's license in case the conditions that led the NBS to grant the license no longer exist. The Banking Supervision Department of the NBS is involved in the licensing process with regard to assessing the proposed business plan. Although it is preferable that the supervision department is involved from the very beginning in the licensing process, this approach highlights the importance of adequate internal coordination within the NBS.
Assessment	*Compliant*
Comments	
Principle 4.	**Transfer of significant ownership**. The supervisor has the power to review and reject any proposals to transfer significant ownership or controlling interests held directly or indirectly in existing banks to other parties.
Description	The 2005 Law on Banks has substantially strengthened the legal framework for the transfer of significant ownership. Significant and controlling participations are explicitly defined in Art 2 of the Law on Banks, while the bottom threshold for obtaining prior regulatory approval for acquiring direct or indirect ownership in banks has been lowered in line with international best practices. *Significant* participation exists when one person has: (a) Direct or indirect right or ability to realize 20 percent or more of voting rights of a legal entity, and/or direct or indirect ownership of 20 percent or more of capital of such legal entity; or (b)) The ability in fact to exercise influence over the management of a legal entity or over the business policy of such legal entity.

	Controlling participation exists when one person has: (a) Direct or indirect right or ability to realize 50 percent or more of voting rights of a legal entity, and/or direct or indirect ownership of 50 percent or more of capital of such legal entity; or (b) The ability to elect at least half of the members of the board of directors or other management body in such legal entity; or (c) The ability in fact to exercise dominant influence over the management of a legal entity or over the business policy of such legal entity. The supervisory approval process for changes in ownership (Art 94) states that prior NBS approval is required if the planned acquisition exceeds 5 percent of the voting rights. A ladder of threshold applies to the acquisition of additional bank shares (5-20 percent, over 20-33 percent, over 33-50 percent and over 50 percent of voting rights). The NBS can refuse on various grounds, including the financial condition or business reputation of the applicant, if, for example, the granting of consent would violate competition or pose a risk to safe and sound and legally management of the bank. Article 100 states a number of exemptions from regulatory approval by the NBS (inheritance, legal succession or other acquisition independent of the will of the acquirer). The Law on Banks also requires banks to inform the NBS at least once a year (or upon the request of the NBS) of the identities of all participants in the bank. Banks also need to inform the NBS of any changes of participation in the bank (Art 101). The Law on Banks (Art 98) provides the NBS the authority to nullify earlier supervisory clearance for the acquisition of ownership if it determines that the requirements for granting the consent are no longer met or if the owner uses his rights in a way that jeopardizes the stability of the bank.
Assessment	*Compliant*
Comments	
Principle 5.	**Major acquisitions.** The supervisor has the power to review major acquisitions or investments by a bank, against prescribed criteria, including the establishment of cross-border operations, and confirming that corporate affiliations or structures do not expose the bank to undue risks or hinder effective supervision.
Description	Article 34 of the Law on Banks states that the investment of a bank in a single non-financial sector person may not exceed 10 percent of the bank's capital, while total investments of a bank in non-financial persons and fixed assets may not exceed 60 percent of the bank's capital. Banks may only establish or acquire subordinated companies in the financial sector and only after obtaining with NBS consent (Art 124). The general supervisory approval process for obtaining ownership in banks applies (see BCP 4). A body of criteria on the basis of which proposed acquisitions of *banks* are assessed is in place (Art 133), covering such aspects as (i) the financial resilience of the acquiring bank, (ii) whether the acquiring bank's organization can adequately handle the risks in business risks resulting from the integration of the acquired bank and (iii) the economic rationale of the acquisition and its impact on competition. The main shortcoming is that the supervisory approval process in evaluating financial sector acquisitions only relates to the acquisition of banks. It does not explicitly address the acquisition of non-bank financial institutions, such as insurance companies, pension funds, brokers, and leasing companies.
Assessment	*Largely compliant*
Comments	Although cross-sectoral ownership linkages between banks and non-financial institutions are as of yet of limited importance, it is recommended that these criteria are

	broadened to include the acquisition of non-bank financial persons. This would provide the NBS with a clearer framework on the basis of which such acquisition proposals should be assessed, thereby strengthening the NBS's awareness of the risks that non-banking activities can pose for Serbian banks.
Principle 6.	**Capital adequacy.** Supervisors must set prudent and appropriate minimum capital adequacy requirements for banks that reflect the risks that the bank undertakes, and must define the components of capital, bearing in mind its ability to absorb losses. At least for internationally active banks, these requirements must not be less than those established in the applicable Basel requirement.
Description	Article 23 of the Law on Banks provides the NBS to set Capital Adequacy Requirements (CAR), while it also grants the NBS the authority to determine a higher capital adequacy ratio if deemed necessary on the basis of the risk profile of an institution. The minimum capital adequacy requirement is 12 percent. An absolute capital minimum of EUR 10 million applies. Banks are required to comply with the capital requirements at all times, that is, to keep its capital at least at the level needed to ensure that all the risks are adequately covered. The capital of a bank is the sum of core (Tier 1) and supplementary capital (Tier 2 and Tier 3), reduced by deductibles in accordance with international practices: Core capital must constitute at least 50 percent of the bank's capital. **Tier 1 capital** consists of: • paid in capital, except for cumulative preferred stock; • premium on issue against the bank's equity stock, excluding cumulative preferred stock; • provisions other than provisions for general banking risks; • retained earnings allocated to core capital, and • capital gains arising from the acquisition and alienation of the bank's shares. **Deductions from Tier 1** capital are as follows: • losses from current and preceding years; • capital gains arising from the acquisition and alienation of own shares; • intangible assets in the form of goodwill, licenses, patents and trademarks, and • acquired own shares of the bank, excluding cumulative preferred stock. **Supplementary capital** (Tier 2 and 3) consists of: • paid up portion of the share capital against the bank's cumulative preferred stock; • premium on issue on the cumulative preferred stock; • revaluation reserves referring to fixed assets and share in capital; • provisions against general banking risks (maximum of 1.25 percent of credit risk-weighted assets); • hybrid instruments; • subordinated liabilities, and • Tier 3 (short-term subordinated debt). **Deductions from supplementary capital** are as follows: • acquired own cumulative preferred stock of the bank; and • the amount of subordinated liabilities exceeding 50 percent of the bank's core capital. **Deductions from total capital** are as follows:

- direct or indirect investments in banks and other financial sector entities;
- all receivables and potential obligations from entities related with the bank; and
- short-falls of special provisions against potential losses.

Since prudential capital may significantly differ from equity components stated in the financial reports, under IFRS, a restatement is made taking provisions, as required by NBS-decision into account and canceling the write-offs on the assets concerned.

The NBS has applied risk weights that, for some asset categories, are conservative compared to other countries in the region (see Table 3). Faced with rapid foreign-currency lending in the run-up to the 2008 crisis, a special 125 percent risk-weight was applied to unsecured foreign currency related lending. Also, risk weights for housing loans are relatively conservative compared with a number of regional peers. Loan classification and provisioning rules are prudent too (see BCP 8). By contrast, the highest risk weights for loans to banks and loans to governments are lower than for countries that have introduced the CRD.

Table 4. Regional Comparison of Capital Adequacy Requirements

	Bulgaria Czech Rep. Romania	**Croatia**	**Serbia**
Minimum CAR	12% 8% 10%	10%[2]	12%
Risk weights for selected asset categories Corporate	Standardized approach Basel II 20% (AAA to AA-) to 150% (below B-)	100%, unless secured by residential property and/or forex denominated	100%, unless secured by residential property and/or forex denominated
Sovereign	0% (AAA to AA-) to 150% (below B-)	0% (OECD and Serbia) to 100% (other)	0% (OECD and Serbia) to 100% (other)
Bank	20% (AAA to AA-) to 150% (below B-)	20% on domestic banks and foreign banks with “adequate creditworthiness	20% (BBB and up) to 50% (< BBB)
Retail	75% (CZ, RO) – 100% (BG)	100% unless secured by deposits or pledged	100%, unless secured by residential property and/or forex

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

Claims secured by residential property	35% (CZ, RO) – 50% (BG)	property 50% if fully secured by mortgage or property	denominated 50% (dinar or hedged) or 75% (unhedged forex position)
Unsecured foreign currency loans	No specific risk weights for foreign currency loans	Foreign exchange risk captured in denominator of CAR	125% for borrowers with unmatched foreign currency position

Sources: BNB, CNB, BNR, HNB and NBS

In order to slow down buoyant credit, growth limits have been in place since end-2007—first at 150 percent, and now at 200 percent of core capital. As a result, major players not only restricted lending, but also drastically increased capital. Thanks to these conservative prudential policies, Serbian banks were (and are) amongst the best-capitalized in the region at the onset of the financial crisis, with capital adequacy around 20 percent. These solvency buffers have served the Serbia well in weathering the turmoil.

The NBS aims for full Basel II implementation as of January 2011. This will require NBS to further upgrade its internal risk assessment system (see also BCP 20) and to set standards for banks' internal capital assessment processes.

Assessment	*Largely compliant*
Comments	NBS is recommended to consider aligning its capital requirements framework to that of most EU-countries since justification for the existing divergences tends to disappear and these tend to offer international groups some room for supervisory arbitrage.
Principle 7.	**Risk management process.** Supervisors must be satisfied that banks and banking groups have in place a comprehensive risk management process (including Board and senior management oversight) to identify, evaluate, monitor and control or mitigate all material risks and to assess their overall capital adequacy in relation to their risk profile. These processes should be commensurate with the size and complexity of the institution.
Description	The Law on Banks contains a general requirement that banks are to organize themselves in a way that allows for risks to be managed adequately. This general provision is further substantiated in the NBS's regulations (Decision on Risk Management). The regulation was strongly inspired by the corresponding BCBS guidance. The overall governance regulation and the specific regulation on risk management clearly define that banks' boards are responsible for defining and supervising a bank's risk-taking policy and risk management strategy. Since activities of Serbian banks are as of today not overly sophisticated or diversified, the composition of boards seems at present reasonably adequate in terms of knowledge and experience to cope with this responsibility.[3] However, as banks, be it subsidiaries of foreign banks, are venturing

[3] Requirements today only ensure three board members to have knowledge or experience in finance.

	into new activities, the NBS should ensure that requirements on boards members' skills remain commensurate to the activity and level of complexity of the institution. Banks are required to establish within their management structure a proper and independent risk management function that ensures adequate risk measurement and monitoring, enabling management and board to fully assume their responsibilities. The NBS gives adequate attention to internal risk reporting with banks, the adequacy of risk measurement techniques used and management attention for risk management. Moreover, the comprehensive reporting framework (see Decisions on regular and ad hoc reporting) enables BS to monitor banks' risk profile adequately, since relevant and comprehensive information on all risk exposures of banks is available on a timely basis. Onsite examinations give due attention to the status and functioning of the risk management function, with particular emphasis on the risk categories distinguished by the NBS and to the internal reporting and lines of responsibility. There is however a need for further capacity building in order to allow for more qualitative approaches towards banks' organization and systems. In order to ensure consistency, the NBS needs to issue regulations or guidance for the management of all risk categories, including IRBB, market risk and specific aspects of operational risk.
Assessment	*Materially non-compliant*
Comments	The overall supervisory approach as established in the Decision on Risk Management appears to be adequate in view of the current structure and activities of Serbian banks. The main impediment for a higher grading is the lack of specific regulation dealing with risk management areas other than credit risk and liquidity risk. It is to be expected that this shortcoming will be remedied in the medium term as new regulation is being prepared as part of the Basel II preparations. A largely compliant score is thus within reach. NBS performs onsite inspection on the quality of risk management processes and has imposed remedial actions to several banks in order to improve quality of their risk management. Still, this area could be further improved in order to assess whether these policies and procedures are adequate given the overall size, complexity and characteristics of the financial institution involved and adherence thereto is adequately ensured. This again highlights the importance of further building supervisory capacity at the NBS.
Principle 8.	**Credit risk.** Supervisors must be satisfied that banks have a credit risk management process that takes into account the risk profile of the institution, with prudent policies and processes to identify, measure, monitor and control credit risk (including counterparty risk). This would include the granting of loans and making of investments, the evaluation of the quality of such loans and investments, and the ongoing management of the loan and investment portfolios.
Description	Stress tests have confirmed that credit risk is by far the main banking risk category in Serbia. By force of the general risk management provision in the Law on Banks, the NBS requires banks to set out adequate and proportionate risk management arrangements for credit risk. The risk management process within banks, as prescribed by this regulation is to be comprehensive and covers adequately all counterparty risk, categorized by type of counterpart. In particular with regard to the granting and monitoring processes, the NBS-regulation appears to be adequate given that Serbian

	banks generally are not engaged in sophisticated and complex operations. Of all the risk categories, credit (counterparty) risk receives most attention in onsite inspections. This is justified by the asset structure of Serbian banks and their activity profiles, which consists primarily of relatively simple loans. Inspection should allow NBS, on the basis of the methodology set out in the inspection manual, to ensure that banks' systems adequately measure and monitor counterparty risk. Although qualitative assessments as of yet play a limited role in supervisory practices, the focus on credit risk is such that the assessments seem sufficient for NBS to adequately monitor banks' performance in monitoring the credit risk inherent to their present activity. Moreover, the detailed reporting requirement over asset classification and provisioning allow NBS to monitor on a timely basis and in sufficient detail banks' credit risk. At the same time such reporting is in itself a powerful tool for banks' management as it should facilitate commensurate internal reporting. As explained in BCP 9, the classification and provisioning requirements issued by NBS can be considered conservative. This induces banks to take a prudent stance as to defining their risk appetite in the loan policy and in monitoring it on an ongoing basis. As discussed under BCP 6, Serbia has taken recourse to prudential regulation in order to slow rapid credit growth, especially in the area of consumer loans. It has done so by imposing limits on the ratio of the consumer credit portfolio to core capital. Banks responded by mobilizing core capital. This policy has had advantages in terms of boosting banks' capital adequacy while pulling the brakes on excessive credit growth. Nonetheless, this policy may expose the regulator to undue pressure to relax requirements when economic stimuli are deemed necessary.
Assessment	*Compliant*
Comments	The regulatory framework and the supervisory practice are in compliance with all essential criteria. NBS is recommended to monitor particularly in this period banks' strategies and practices with regard to restructuring and/or rescheduling loans.
Principle 9.	**Problem assets, provisions and reserves**. Supervisors must be satisfied that banks establish and adhere to adequate policies and processes for managing problem assets and evaluating the adequacy of provisions and reserves.
Description	Following the 2005 FSAP recommendations, the NBS has overhauled the regulatory framework for asset classification and provisioning. The new regulation is strongly inspired by approaches followed by several European supervisors and envisages classification of loans in five categories. Banks are allowed to continue interest accruals up to the moment when the customer incurs payment arrears of over 90 days. The regulation on asset classification and provisioning comprises 20 pages of guidance as to the principles and criteria for establishing a comprehensive classification framework. It applies to loans but also to other asset categories, including off-balance sheet assets. The main criterion for classification is number of past-due days of the payments. Thresholds are 30, 60, 90 and 180 days of payment delay respectively. The guidance also requires banks to take into account other factors influencing credit risk on the particular exposure, which may warrant a worse classification and provisioning category than on the basis of timeliness of the borrower's payment behavior alone:

- the presence of collateral, whereby this collateral is subdivided into the categories adequate, acceptable and insufficient. The presence and quality of collateral is affecting both the classification and the definition of net exposure;
- the financial position of the borrower; although the criteria appear to be not very precise in the classification criteria, they are substantiated by reference to more concrete elements; for private customers this is in essence the ratio of debt service against total income and for this criterion a separate benchmark is to be used for mortgage loans (30 percent) and for total exposure (50 percent); for corporate and SME, the focus is to be on cash flow, working capital and profit (loss)[4];
- a restructuring or rescheduling of the loan, which requires banks to downgrade the loan by at least one category, regardless of other considerations on the quality (collateral, repayment capacity);
- the same requirement is imposed for loans in foreign currencies. Over and above their classification unhedged unsecured foreign currency loans carry an increased risk-weight of 125 percent for CAR-purposes; and
- the absence, particularly for loans to corporates and SME, of recent financial information in the credit file entails also a requirement to downgrade the loan.

A specific feature of the framework is that it does not always require that the default of a borrower on a loan implies classification of all exposures to this borrower (see table; "contamination clauses"). The availability of high-quality collateral may prevent the non-delinquent exposures from similar classification. A default is however at the least considered a deterioration of the customer's financial status for classification purposes. Consideration is also given to collateral to define the classification. This principle is applied rigorously, which implies that any loan may on the basis of the quality of the underlying collateral be sliced into separate components, each of which is to be classified into (different) classification categories. So a single delinquent loan covered partly by "adequate" and partly by "acceptable" collateral, with the remainder being unsecured, is classified into three categories with the corresponding provisioning levels.

The system and the criteria appear comprehensive, relevant and prudent in comparison with other countries in the region. Substantial differences exist between these countries, notably with regard to provisioning levels, and for overdue loans classification. Serbian regulation seems to be on the stricter side, but overall Romania appears to have the most preemptive regime.

Table 5. Regional Comparison of Loan Classification Rules

	Bulgaria	**Czech Republic**	**Romania**	**Serbia**
Classification categories	Standard Watch Non performing Loss	Standard Watch Substandard Doubtful Loss	Standard Watch Substandard Doubtful Loss	Standard Watch Substandard Doubtful Loss

[4] Essentially the assessment whether cash-flow and/or working capital are positive or negative.

Days past-due and provisioning levels				
0 – 15 days	0%	0%	0%	1 – 2%
16 – 30 days			5%	
31 – 60 days	10%	1%	20%	5 – 10%
61 – 90 days			50%	20 – 35%
91 – 180 days	50%	20%	100%	40 – 75%
180 – 360 days	100%	50%		100%
> 361 days		100%		
Loan classification possible on the basis of deteriorated financial status borrower alone	Possible for all classification categories	Only possible if repayment capacity is seriously affected (doubtful, loss)	Possible for all classification categories	Possible for all classification categories
Contamination clauses	Yes	Yes	Yes	Yes*

* Other loans may be given a more favorable classification than the delinquent loan on the basis of the quality of the collateral.
Sources: BNB, CNB, BNR and NBS

It is however questionable whether their sophistication is necessary given the relatively simple character of Serbian banks and with the sometimes limited availability of reliable data. In practice, the judgmental element may lead to substantial interpretational differences between banks and the NBS, with potentially far-reaching consequences for provisioning. The scope for such differences of views was illustrated when NBS staff presented a case study on an existing bank. In this particular example, the NBS and the bank had diverging interpretation on 1/3 of the loan portfolio, with some of the differences being quite extreme.

Following onsite verifications, the NBS sometimes requires very significant reclassifications for a large portion of the loan portfolio; frequent allegations by some banks of an "utterly strict" stance of NBS show that the present regulation cannot adequately provide for security with respect to banks' loan classification being adequate, consistent and transparent. NBS is recommended to consider whether a less elaborate and more precisely defined set of criteria would not better meet the needs of both banks and supervisors with respect to provide for a clear, transparent and broadly accepted classification framework for all types of loans.

In a similar vein, it is worthwhile to reconsider certain aspects of the provisioning guidelines for banks. For each class of exposures, the classification regime prescribes

	wide provisioning brackets (see the table above); these brackets are established at respectively 1-2 %, 5-10%, 20-35 %, 40-75 % and 100 % for the classes A to E. The regulation does not provide further guidance as to the specific provisioning levels within these broad brackets. As for the classification in itself, this leaves scope for diverging interpretations with potentially important repercussions for provisioning. According to NBS-staff members, there is a strong tendency with banks to systematically provision in the lower end of the bracket. NBS inspectors, when performing onsite verifications, often face allegations of being unreasonably demanding. The aforementioned case study presented by NBS illustrated that the potential impact of different judgments may be very significant. The joint impact of reclassification and resetting of provisioning levels within the existing framework was for the reviewed portfolio to increase the required provisions by approximately 50%. As Serbia has introduced IFRS-reporting in full for financial institutions, the regular financial reporting is also IFRS-compliant. This implies that banks can only write off assets for incurred losses. The concept of provisioning for *expected* losses on loan portfolios is explicitly excluded in IFRS. The reporting on loan provisioning is thus, as under the regime of “prudential filters” within the EU[5], a specific set of reporting documents, which are not based on banks’ statutory accounts, but rather on an internal assessment and classification, separate from accounting. Reports have to be submitted in electronic version on a quarterly basis. The offsite division of NBS’s Supervisory Department (SD) builds on this reporting to perform an analysis of each bank’s situation with regard to NPL ratios and to provisioning, both on a comparative basis and over time. It can, however, only review on a rather gross basis to what extent provisioning figures are in line with the imposed provisioning brackets imposed by regulation (see above). The result of the analysis is an important and standing part of the reporting to management of the SD on the global financial and prudential situation of each bank and of the overall sector.
Assessment	*Compliant*
Comments	The Serbian classification and provisioning rules are clear and prudent regarding the number of overdue days. This in itself justifies a compliant score for this BCP, as the judgmental elements regarding the borrower’s financial status and quality of the collateral allow for stricter classification than on the basis of timeliness of the payment alone. In practice, these qualitative elements and the practice of formulating brackets rather than minimum provisioning levels seem to create scope for differences in interpretation. In this context, it is recommended that the NBS consider to establish a more precise set of criteria for loan classification that meet the needs of both banks and supervisors with respect to provide for a classification framework for all types of exposures and for a provisioning regime that are clear, transparent and broadly accepted. In the same effort NBS could consider whether the practice of automatically downgrading of exposures in foreign currency (i.e. exposures for which the methodology determined that change of FX has a negative effect on the borrower’s ability to fulfill its obligations or for which the bank does not apply prescribed methodology) is justified, given that unhedged exposures in foreign currency are also subject to higher risk weights. Due regard needs to be given, however, to the potential

[5] See for the concept and its elaboration CEBS’s guidance on prudential reporting.

	for "forex-induced credit risk" in the loan portfolios of banks.
Principle 10.	**Large exposure limits.** Supervisors must be satisfied that banks have policies and processes that enable management to identify and manage concentrations within the portfolio, and supervisors must set prudential limits to restrict bank exposures to single counterparties or groups of connected counterparties.
Description	Following international best practices, large exposures are defined as exposures to a single person or a group of related persons amounting to at least 10% of the bank's capital. The NBS applies a ceiling for exposures of a bank to a single person or a group of related persons of 25% of the bank's capital. "Exposures" include on-balance sheet receivables as well as off-balance sheet exposure. Article 33 in Law on Banks prescribes a range of 400% and 800% of the bank's capital, within which NBS can set maximum level of total large exposures in its bylaw. The Law on Banks grants the NBS considerable flexibility in defining groups of connected counterparties, which can include parties that are related in such a way that according to the NBS there is a real risk of transfer of losses (Art 2). The 2005 Law on Banks, which contrary to its predecessor provides the basis for consolidated supervision, has closed loopholes created by the conduct of supervision on a solo basis. The NBS commented that it generally has sufficient information to identify portfolio concentrations, but that it doesn't receive the necessary information to highlight geographical concentrations.
Assessment	*Compliant*
Comments	It is recommended that reporting requirements are upgraded in order to allow the NBS to highlight geographical portfolio concentrations. However, given that Serbia is a geographically small country, this is not a material issue.
Principle 11.	**Exposures to related parties.** In order to prevent abuses arising from exposures (both on balance sheet and off balance sheet) to related parties and to address conflict of interest, supervisors must have in place requirements that banks extend exposures to related companies and individuals on an arm's length basis; these exposures are effectively monitored; appropriate steps are taken to control or mitigate the risks; and write-offs of such exposures are made according to standard policies and processes.
Description	The Law on Banks' definition of related parties covers the bank's subsidiaries and affiliates and other parties under control of the bank, the direct business interest of key players of the bank and the business interests of family members. The respective provisions of the Law on Banks are drafted in a way that grants the NBS considerable flexibility in defining groups of related parties (Art 2). The Law on Banks explicitly forbids banks to grant more favorable conditions to related parties (art 37). Related party exposures are included in banks' reporting requirements (Reporting Guidelines for Banks). However, as the NBS can apply a flexible definition of related parties, there may be scope for differences in interpretations between banks and supervisors. Although the 2008 Decision on Risk Management clarifies the range of receivables (which includes off-balance sheet exposures) additional guidance as to which parties are considered related parties could be helpful. The NBS applies a limit of 5% of capital to exposures to a single related party, while the aggregate exposure to related parties may not exceed 20% of the bank's capital (Art. 33). These limits are considerably stricter than the limits for exposures to a single or a group of connected counterparties, which may not exceed 25% of the bank's capital. Art. 38 of the Law on Banks specifies that the beneficiaries from intended related party transactions are not part in the loan approval process. Prior board approval is required for granting loans to related parties,

	except credits collateralized by either high quality debt securities or linked deposits.
Assessment	*Largely Compliant*
Comments	The NBS's flexible definition of related parties is helpful in deciding on a case-by-case basis whether material linkages exist. Additional guidance as to which parties are considered related parties would be useful in order to prevent differences of interpretation between the banks and the NBS as to which parties are related.
Principle 12.	**Country and transfer risks.** Supervisors must be satisfied that banks have adequate policies and processes for identifying, measuring, monitoring and controlling country risk and transfer risk in their international lending and investment activities, and for maintaining adequate provisions and reserves against such risks.
Description	Country risk is among the risk categories highlighted by the NBS in the Decision on Risk Management (p. 8-9). Country risk is defined as the risk of negative effects on the financial result and capital of the bank due to the bank's inability to collect receivables for reasons arising from political, economic or social circumstances in the country of origin. Banks are required to define limits of exposure to country risk individually by a borrower's country of origin, or by region in case of concentration of exposure on a specific geographic area. In practice country risk receives limited supervisory attention. It is mostly left to banks to define limits and provisioning percentages and put in place appropriate risk management policies and procedures. Although this is understandable given that Serbian banks have only very limited foreign operations (besides transactions with parent banks), an upgrading of the supervisory practices is called for.
Assessment	*Materially Non Compliant*
Comments	An upgrading of supervisory framework for country risk, by issuing secondary legislation specifying the minimal requirements for managing country risk.
Principle 13.	**Market risk.** Supervisors must be satisfied that banks have in place policies and processes that accurately identify, measure, monitor and control market risks; supervisors should have powers to impose specific limits and/or a specific capital charge on market risk exposures, if warranted.
Description	Market risk is among the risk categories mentioned explicitly in the Law on Banks (Art. 32). The article obliges banks to prescribe special policies and procedures for identification and management of market risks and to report regularly to the bank's exposure to market risk. In the Decision on Risk Management, the NBS defines market risks as the risks of negative effects on the financial result and capital of the bank caused by changes in the value of the portfolio of financial instruments. The NBS distinguishes between exchange rate risk and other market risks. For exchange rate risk, limits are in force to the maximum open foreign currency position that banks can take, which may not exceed 10% of its capital. In the context of the crisis this limit was temporarily relaxed to 20% of capital. Guidance on other categories of market risks is less prescriptive. Other than the Decision on Risk Management, the NBS has not issued specific regulation on market risk. In assessing a bank's exposure to the other categories of market risks, banks need to make an assessment of losses in normal and extraordinary market conditions. Loss limits need to reflect a bank's levels of capital and income. Loss limits also must be commensurate with the assessed risk level and with the highest permissible loss in a specific time period. There is no requirement for banks to conduct stress tests and set up contingency planning mechanisms as part of market risk management. Banks

	are required to regularly review their loss limits. Banks should also monitor market risks by engaging in daily examinations of trading book positions, compliance with set limits, and trading activity results. Reports on the examination of trading book positions shall contain a review of current and cumulative results at monthly and annual levels. The Serbian authorities indicated in the discussions that foreign banks in Serbia mostly have centralized risk management policies that are put to use in Serbia. Serbian subsidiaries use the same models for managing market risks as their parent banks, but the NBS requires adaptations to ensure adequacy for local operations. Model validation appears to be difficult due to lack of data and shortages of IT specialists. Limits are usually defined by the subsidiary and subsequently approved by the parent. The NBS noted that it is hard to determine whether limits are suitable given the overall characteristics of financial institutions.
Assessment	*Materially Non Compliant*
Comments	Although Serbian banks currently have relatively modest trading activities, the NBS is well-advised to step up supervisory area of market risk. The current supervisory approach focuses primarily on important procedural aspects, including verification whether an independent risk function and independent reporting lines are in place. In addition to issuing specific regulation on market risk, the NBS faces the challenge of taking market risk supervision a step further by assessing the specificities of the limits and their appropriateness given the overall characteristics of the institution involved. Scheduled Basel II implementation as of 2011 makes this an urgent issue.
Principle 14.	**Liquidity risk.** Supervisors must be satisfied that banks have a liquidity management strategy that takes into account the risk profile of the institution, with prudent policies and processes to identify, measure, monitor and control liquidity risk, and to manage liquidity on a day-to-day basis. Supervisors require banks to have contingency plans for handling liquidity problems.
Description	Liquidity risk is among the risk categories explicitly mentioned in the Law on Banks (Art 30). The NBS requires that the competent body of the bank adopts and enforces liquidity management policies, including a planning of projected inflow and outflow and liquidity monitoring. These demands are further substantiated in a recent Decision on Liquidity Risk Management. It requires proper control activities by the bank's executive board, bank's staff and staff responsible for liquidity management (Decision on Liquidity Risk, para 9), while Art 82 of the Law on Banks assigns final responsibility for internal controls to the Executive Board. The adequacy, reliability and efficiency of the arrangements is to be regularly assessed through internal audits. Liquidity risk supervision by the NBS is based on standard liquidity ratios (see Gazette and in the Questionnaire dated May 15, 2009). This ratio is calculated as the sum of the bank's liquid receivables divided by the sum of bank's liabilities payable on demand or with no predetermined maturity and liabilities due within one month. The NBS applies the following requirements for the liquidity ratio: • at least 1.0 if calculated as the average liquidity ratio for all business days in a month; • at least 0.9 for more than three days in a row; • at least 0.8 if calculated for one business day only. Off-balance sheet receivables are excluded in the calculation of receivables, as are classified receivables in the "loss" and "doubtful" category. Weights are applied to banks' liabilities with no agreed maturity, which includes a number of off-balance sheet items:

	• 40% of demand deposits by banks • 20% of demand deposits by other depositors • 10% of savings deposits • 5% of guarantees and other sureties • 20% of undisbursed irrevocable credit facilities. Banks are to inform the supervisor of any shortfalls within one business day. As of July 1, 2009 banks are also to have liquidity contingency plans in place. Banks are required to adopt procedures to measure and monitor net cash flows on the basis of a gap analysis (i.e., by monitoring assets and liabilities for the remaining maturity period, measuring and comparing cash inflow and outflow, as well as by daily monitoring of net cash flow per maturity buckets). Banks are required to establish procedures for measuring and monitoring liquidity risk in significant currencies (euros, and to a far lesser extent Swiss francs and dollars) and in total amount. The NBS currently does not require banks to perform stress tests nor frequently review underlying assumptions. The current regulatory framework also does not explicitly require that the impact of other risks (e.g. credit, market and operational risk) to bank's overall liquidity strategy is taken into consideration. With liquid assets accounting for 42% of total assets, and covering 67% of short-term liabilities, Serbian banks are quite liquid. Loans to deposits currently stood at around 100 percent in June 2009. Liquidity was tested in October following a bank run during which almost 20 percent of household savings deposits were withdrawn, but more than a half of the withdrawn deposits have returned.
Assessment	*Largely Compliant*
Comments	The NBS should consider enhancing the current secondary legislation in the area of liquidity risk management in a number of aspects in order to ensure that the impact of other risks (e.g. credit, counterparty market and operational risk) is taken into account in the bank's overall liquidity strategy. This could be done by upgrading the elements of the BIS's Principles for Liquidity Risk Management into secondary legislation.
Principle 15.	**Operational risk.** Supervisors must be satisfied that banks have in place risk management policies and processes to identify, assess, monitor and control/mitigate operational risk. These policies and processes should be commensurate with the size and complexity of the bank.
Description	NBS has issued partial regulation on operational risk, in particular on business continuity planning for banks under the general legal provision on proper organization and internal control. It requires banks' boards to approve strategies and procedures for ensuring adequate management of certain aspects of operational risk under all circumstances. There is, however, no comprehensive guidance or regulation on operational risk overall. As part of the onsite inspection plans a review of the effective implementation of the strategy for BCP set by the bank's boards and of the relevant procedures is performed. The effectiveness of this check is however significantly hampered by the absence of adequate IT-audit capacity within the onsite division. Given that the quality of IT-systems and of IT-security is a cornerstone of operational risk management, this is a major weakness in the overall approach to operational risk mitigation with banks by NBS.

	Within the information obligations for banks towards the NBS, it is clearly stipulated that banks need to inform the NBS about major incidents potentially affecting business continuity or operational integrity of banks' internal systems and processes or entailing potential losses over a certain threshold. The NBS's regulations on outsourcing are broadly in line with the requirements of essential criterion 8. They could, however, be upgraded by fully aligning them with international best practices; for example, the guidance issued by CEBS, particular with regard to control environment and internal audit.
Assessment	*Materially non-compliant*
Comments	The NBS is strongly recommended to prioritize capacity building with BS's onsite division for allowing it to fully and adequately assess all aspects of banks' operational risk management.
Principle 16.	**Interest rate risk in the banking book.** Supervisors must be satisfied that banks have effective systems in place to identify, measure, monitor and control interest rate risk in the banking book, including a well defined strategy that has been approved by the Board and implemented by senior management; these should be appropriate to the size and complexity of such risk..
Description	The NBS provides general guidance for the management of interest rate risk in the Decision on Risk Management, but it has not issued specific regulation on the topic. The NBS distinguishes (i) maturity mismatch and repricing risk, (ii) base risk and (iii) optionality risk. It requires banks board and management to set and review strategy, set loss limits and set up procedures for managing, monitoring and mitigating interest rate risk in the banking book (IRBB). Through onsite inspection, i.e. by verifying compliance of reporting requirements NBS monitors banks' exposure to and management of IRBB. The activities of Serbian banks as of today are not overly sophisticated and do therefore not put high demands to the standards for IRBB management. This may change as the Serbian financial sector grows and engages in more complex activities. Through prudential reporting, the NBS ensures adequate follow-up on IRBB risk. It requires banks, in particular those with potential significant impact, to periodically perform limited types of scenario testing with respect to potential impact of IRBB.
Assessment	*Materially non-compliant*
Comments	It is recommended that the NBS issues specific regulation on IRBB, so as to provide banks with appropriate guidance.
Principle 17.	**Internal control and audit.** Supervisors must be satisfied that banks have in place internal controls that are adequate for the size and complexity of their business. These should include clear arrangements for delegating authority and responsibility; separation of the functions that involve committing the bank, paying away its funds, and accounting for its assets and liabilities; reconciliation of these processes; safeguarding the bank's assets; and appropriate independent internal audit and compliance functions to test adherence to these controls as well as applicable laws and regulations.
Description	Internal control and audit requirements are anchored in Art. 82 of the Law on Banks, which contains strict governance standards for banks. Overall corporate governance principles are in accordance with international standards. The responsibilities of board and executive management are clearly delineated and ensure proper oversight and control over banks' operations, organization and financial position.

	The NBS has full authority over the appointment and removal of board and executive management members. It can remove members whenever they no longer meet fit and proper standards or when they no longer fulfill their responsibilities. The NBS has issued guidance on internal control and internal audit in banks in line with international good practice based on Art 82 of the Law on Banks. Generally accepted control features, including an appropriate division of responsibilities between the operational, recording and supervisory functions of banks and “four eyes principle” are included. Banks are required by law (Art 85 Law on Banks) to establish an independent internal audit function. Its responsibilities need to be clearly defined. The principles in Art 85 ensure independency of the internal audit function and adequate reporting lines towards management and board. Internal audit is required to cover all activities of the bank to ensure the integrity and respect of its systems and internal controls. It has full access to all staff and to all functions, systems and records of the bank. There is, however, no explicit requirement ensuring that internal audit also has full access to outsourced functions. Although there is a requirement for banks to establish an equivalent of an audit committee (Committee for Monitoring Business Activities of the Bank), its features are not fully in line with international practice in that it only requires one independent director. According to Article 83 of the Law on Banks, Serbian banks are required to have a compliance function. The definition of its role and responsibilities is inspired by international good practice, but the scope should be broadened somewhat. Compliance should indeed fully cover all domains where breaches of laws or regulations potentially expose the bank to reputational risk.
Assessment	*Largely compliant*
Comments	NBS is encouraged to align the scope of compliance function formally to international best practice. Furthermore, particularly the reporting line of internal audit could be enhanced by the requirement to install an audit committee according to international standards.
Principle 18.	**Abuse of financial services.** Supervisors must be satisfied that banks have adequate policies and processes in place, including strict “know-your-customer” rules, that promote high ethical and professional standards in the financial sector and prevent the bank from being used, intentionally or unintentionally, for criminal activities.
Description	The Law on Anti-Money Laundering (AML) and Combating the Financing of Terrorism (CFT; "RS Official Gazette" No. 20/2009) constitutes the legal framework in the area of anti-money laundering. In addition to the FIU (APML) and the NBS, other domestic agencies involved in supervision are the Securities Commission, the Tax Administration, the Ministry of Finance, the Bar Association and the Chamber of Licensed Auditors. The APML is a member of the Egmont group since 2003. Cooperation between the NBS and the APML seems well-established. The NBS and the APML have an MOU, enabling the exchange of all relevant information. Material problems related to AML/CFT are reported to the NBS, while individual suspicious transactions are reported to the APML (which may subsequently report to the NBS). The NBS exchanges AML/CFT information only with home supervisors with which it has an MOU. When conducting full-scope bank investigations, as well as targeted AML/CFT

	investigations, it is standard routine that the AML specialist of the NBS has a pre-inspection meeting with the APML to receive information about the respective bank. On full-scope inspections, it is also customary that a staff member from the Division for Supervision of Payment and Exchange Operations, which within the NBS is responsible for AML supervision, joins the inspection team. In addition, the NBS also conducts focused AML investigations staffed by the Division for Supervision of Payment and Exchange Operations only. Priorities are defined on the basis of a questionnaire that is sent every 6 months to banks. Aggregate results are posted on the internet. The NBS indicated that, according to APML's reports, an upward trend was recorded in the number of Suspicious Transactions Reports (STRs) in the total banking sector. NBS has the right to activate the general remedial action framework for non compliance with AML and CFT requirements and it may also impose fines. The APML is required by law to report infringements to the public prosecutor. Banks are obliged to: identify and verify the customer, identify the beneficial owner, obtain information on the purpose and intended nature of a business relationship or transaction, and regularly monitor business transactions of the customer and check the consistency of the customer's activities with the nature of the business relationship and the usual scope and type of the customer's business transactions when carrying out a transaction of EUR 15,000 or more, irrespective of whether the transaction is carried out in one or more than one connected operations (Art. 8 and 9 AML/CFT Law). The NBS has relied especially on fines to improve reporting discipline in the financial sector. The minimum content of the know-your-customer (KYC) policies are established in secondary legislation and applies to all financial intermediaries under NBS supervision. The respective Decision covers amongst others: (i) client acceptability considering the level of AML/CTF risk, (ii) classification of clients in risk categories and based on risk factors (iii) customer due diligence, (iv) management of AML/CTF related risks, to which the bank is exposed and (v) training programs. Serbian banks are required to appoint compliance officers (Art. 39, Law on AML and CFT). The compliance officer reports directly to management and is to be given unfettered access to access to data, information, and documentation relevant for his tasks, appropriate human, material, IT, and other resources. The compliance officer enjoys legal protection with respect to disclosure of data and for other legal procedures which may affect performance of his duties. The NBS is not aware of any pending lawsuits against compliance officers. The current Law on AML and CFT does not require banks to systematically screen newly hired personnel. Reporting financial institutions and their employees are not liable for any damage done to customers or third parties for sending AML/CFT data to the APML data and for executing orders of the APML to temporarily suspend execution of transactions or to monitor the financial transactions of a customer (Art .75, Law on AML and CFT). The bank shall not establish or continue a loro correspondent relationship with a bank whose seat is located in a foreign country if a bank has not established a system for the prevention and detection of money laundering and terrorism financing or is not required to apply the regulations in the area of prevention and detection of money laundering and terrorism financing in accordance with the regulations of the foreign country in which it has its seat, or where it is registered (Article 29 (4) AML/CFT Law). Loro correspondent banking relations of Serbian banks with countries that are listed as non-compliant with the international AML/CFT standards at the European Union level

	or higher, are subject to a enhanced due diligence requirement. The requirements include obligation to: identify and verify the customer, identify the beneficial owner, obtain information on the purpose and intended nature of a business relationship or transaction, and regularly monitor business transactions of the customer and check the consistency of the customer's activities with the nature of the business relationship and the usual scope and type of the customer's business transactions, as well as: date of issue and period of validity of the banking license and the name and seat of the competent body of the foreign country which issued the license, description of the system for the prevention and detection of money laundering and terrorism financing in the country of the seat is located, or where the bank has been registered, a mandatory description of internal procedures concerning the prevention and detection of money laundering and terrorism financing, and particularly the procedures regarding customer due diligence, transmission of data on suspicious transactions and persons to the competent bodies, record keeping, internal control, and other procedures adopted by the bank, a written statement of the responsible person in a bank stating that the bank in the state of seat or in the state of registration is under supervision of the competent state body and that it is required to apply the regulations of such state concerning the prevention and detection of money laundering and terrorism financing (Art 29(1) Law on AML and CFT). A written statement stating that the bank does not operate as a shell bank is also required, as well as written statement that the bank does not have any business relationships and or transactions with a shell bank.
Assessment	*Compliant*
Comments	Banks should be required to conduct screenings of new staff as a matter of routinge. While loro correspondent banking relationships are subject to an enhanced due diligence regime, consideration could be given to prohibiting correspondent banking relationships with non-compliant countries altogether.
Principle 19.	**Supervisory approach.** An effective banking supervisory system requires that supervisors develop and maintain a thorough understanding of the operations of individual banks and banking groups, and also of the banking system as a whole, focusing on safety and soundness, and the stability of the banking system.
Description	Thanks to comprehensive reporting requirements (see BCP 21) NBS has ample information on all relevant aspects of its banking sector at its disposal**.** Through analysis of individual data and compilation of aggregate figures it has a good overview of the state of affairs at individual banks as well as the banking sector at large. For this purpose, NBS uses a CAMEL-based methodology. This methodology not only ensures consistency in the supervisory approach towards individual banks, but it is also put to use as a planning and prioritization tool, such as for onsite inspections. Although there is no formalized procedure for a prudential check on new banking activities, the NBS's analysis performed allows for adequate insight into the risk profiles of banks, while reports on inspections facilitate the periodical assessment of their internal control. No formal analysis is currently made of banks' business focus, but the banking sector is at present not very sophisticated and NBS appears to be well aware of the business development of both individual banks and the overall sector. Peer group analysis as well as comparison to the overall sector (both on a cross-sectional basis and through time), both in terms of averages and of time-series, are performed and allow for proper positioning of each institution. The relationships with parent banks and the limited availability of information on their groups may somewhat hamper these efforts, but do not fundamentally affect their effectiveness. Enhanced

	international cooperation should provide NBS with a clear view on the structure, strategy and financial position of groups to which Serbian banks belong. Scenario analysis is used as a way to add a forward looking element to the supervisory approach. To this effect, the banking supervision department cooperates with other departments within the NBS to define appropriate adverse scenarios for such tests. Serbia has at an early stage detected the risks inherent in the rapid development of consumer credit. It has attempted to slow down the growth of this segment, by imposing caps on the consumer credit-capital ratio and through raising risk weights for unhedged unsecured foreign currency lending. The information systems designed for supervisory application, i.e. for financial and for macro-prudential analysis, for registering general information on banks and for performing ad hoc analysis (including stress testing) appear to be performing and reliable. There is, however, room for enhancing the effectiveness of the macro-prudential approach by developing full early warning systems that allow for preventive action in view of evolutions within the banking sector.
Assessment	*Largely compliant*
Comments	NBS is recommended to further formalize its policy and procedures with regard to analysis at the sector-level. The present approach seems broadly adequate given the current size and complexity of the Serbian banking sector and full compliance is within reach. The framework could however be made more forward looking, e.g., by developing a full early warning system.
Principle 20.	**Supervisory techniques.** An effective banking supervisory system should consist of on-site and off-site supervision and regular contacts with bank management.
Description	In addition to the Banking Supervision Department, the NBS has departments for the supervision of insurance companies and voluntary pension funds. The NBS has organized its Banking Supervision Department (BSD) in four divisions, of which offsite analysis and onsite inspection employ some 20 staff members each. There is a legal division (separate from NBS's overall legal department) that employs 11 people, a small division (3 staff members) for research and finance and a large division for the supervision of exchange offices and payment systems (40). The latter will be split-up by year-end, as supervision of exchange offices is being brought under the auspices of the MoF. The remaining staff will be in charge of payment systems and of AML/TF matters for the whole department. The offsite division has also two special units under its auspices, of which one is dedicated to Basel II implementation (4) and the other to stress-testing (3). The remaining staff is divided into four portfolio-teams, each of which is headed by a portfolio manager[6]. Portfolios are constituted according to the country of origin of the parent bank. The domestic banks (both private and public) are divided evenly over the four teams. The offsite analysis department can build on an extensive reporting framework (BCP 21). Reporting inputs enter a comprehensive database that is readily accessible for analytical purposes to management and to the supervisory staff directly concerned. This allows for a comprehensive and well structured information gathering on all key elements for assessing the bank's financial position, profitability and risk profile.

[6] At present not all positions of portfolio managers have been assigned by lack of staff members fulfilling the experience requirements set by management for such function. In this case a deputy portfolio manager is heading the team.

	The NBS has set up a semi-automated analysis system over these reports that provide reasonable assurances for consistency and adequacy. For each bank a set of standardized analysis reports is produced and made available to offsite staff[7]. Moreover, all offsite staff have recourse to a proprietary exploitation program (an enhanced "ACCESS"-program). This allows for deeper or more focused analysis whenever deemed necessary by the offsite staff or by management. Financial analysis is combined with qualitative assessments of banks' organization and management. This qualitative assessment is performed on the basis of the reporting from onsite inspection (see below). The end result is consigned in a CAMEL-based rating system, which was recently updated for better capturing the qualitative aspects of NBS's assessment of banks. Both for the analysis as such and for the reporting to BS and NBS management on banks' position, evolution and risk profile, the department head is elaborating with its team a procedures manual, that is in an advanced stage of preparation. It should better ensure the adequacy and consistency of internal processes and procedures for quantitative analysis. Portfolio managers fulfill a key role in the supervisory process. They are in charge of: • coordinating the overall supervisory approach towards each bank; i.e., defining key elements of its risk profile, proposing prioritization within inspection planning, setting precise timing and planning for supervisory tasks and proposing corrective measures and sanctions for decision; • drafting quarterly reports to NBS management summarizing the main outcomes of the analysis of a bank's financial position and risk profile, the main findings of onsite inspections, other significant elements gathered through contacts with banks staff and management, prior remedial or sanctioning measures taken (if applicable) including follow-up and the position of the bank within pre-defined peer groups. This report is comprehensive but also rather extensive, covering at least four pages of explanatory notes and several pages of supporting tables and graphs; • proposing, on the basis of the information gathered by offsite and onsite, to management potential remedial measures and/or sanctions for consideration and monitor follow-up; • acting as the primary point of contact with banks, both for information gathering by NBS and for responding to banks' requests for information and guidance. The offsite division is also involved in the licensing process with particular emphasis on the "economical" aspects (business plans, capital planning). Inspections by the onsite division mostly follow the annual inspection plan developed by the portfolio managers (see above). The annual inspection plan is submitted to the Supervisory Review Committee (SRC) for approval. This planning covers comprehensive inspections of designated banks and targeted inspections, addressing specific topics for all or a set of banks. The planning leaves room for inspections "on demand" whenever deemed necessary. The present staffing allows for an inspection cycle of "full scope" inspections over three years; on average, full-scope inspections last five weeks (three weeks onsite and one week for preparation and report writing).

[7] Other supervisory staff and management have conditional access to the database; i.e., a hierarchy of access authorizations has been established in order to better ensure confidentiality of supervisory information.

	Inspections are performed by teams under the coordination of team leaders. Teams usually consist of some four members, but the actual size may vary. Each team operates under the responsibility of a team leader. Employees need to have a minimum of five years of work experience to assume the role of team leaders. However, at present there are not enough experienced inspectors to ensure an adequate supply of team leaders. Most inspectors have a broad range of skills, but are somewhat specialized in specific areas. The pool of auditors is however small and some specialist skills, in particular in IT audit are practically unavailable within the supervisory department at the NBS. An inspection manual has been elaborated, covering most areas or onsite tasks. The manual is at present under review since the preparation of Basel II implementation requires a shift in emphasis from mere compliance checking to qualitative assessment of organization, systems, processes, procedures and manuals. The need to review compliance with loan classification and provisioning (BCP 9) absorbs a relatively large amount of human resources and thereby limits the potential to fully perform this shift in the near future. An additional element in this respect is the modest contribution of external auditors[8] , which subsequently leads onsite teams to dedicate significant time to verifying the adequacy of internal and prudential reporting systems with banks. Inspection reports are reviewed by the division head and submitted to the portfolio managers in the offsite division. They are discussed and submitted to NBS management with a proposal for remedial action, if required. The reports are then transmitted to the bank's management and governing board for comments and response and the action plan is finalized. Banks are obliged to report to the NBS about their compliance with recommendations. Usually, banks' compliance with recommendations is also subject to targeted follow-up inspection.
Assessment	*Largely Compliant*
Comments	NBS's management is recommended to strengthen capacity building in the on-site and off-site division, both in quantitative and in qualitative terms, as a priority. To this effect NBS management should consider all elements that can contribute such as budgeting issues, career planning, professional status, education opportunities, salary structure and growth and career perspectives. In particular the need to provide for IT-audit capacity with the onsite division is crucial to enable the division to fully adopt a more risk-based approach and to perform adequate qualitative assessments as required under Basel II. The current focus of onsite on compliance checking needs reconsideration if NBS intends to further pursue full implementation of Basel II, as this requires onsite to shift its focus predominantly to qualitative assessment of banks' organization, systems and management.
Principle 21.	**Supervisory reporting.** Supervisors must have a means of collecting, reviewing and analyzing prudential reports and statistical returns from banks on both a solo and a consolidated basis, and a means of independent verification of these reports, through either on-site examinations or use of external experts.
Description	Based on art 101 of the Law on Banks, NBS has put in place a comprehensive

[8] External auditors of banks have to provide the NBS with a copy of their report and have a fiduciary duty to signal breaches of laws or prudential regulations. They do not contribute, however, to certify the prudential reports or the systems in place to generate such reports.

	reporting regime. The NBS follows a quarterly reporting cycle for structural analysis (balance sheet structure, breakdown of deposits and loan portfolios) and detailed data facilitating the monitoring of banks' CAR. Mandatory reporting items include the composition of capital, major deposit-holders, fixed assets and financial investments and exposures top related parties. More detailed tables need to be reported on asset classification, overall credit risk, impaired loans, large exposures, trading book, several elements of market risk and risk weighted assets (both on and off balance sheet). The NBS requires monthly reporting on balance sheet and P/L-account, cash-flow, total deposits and loans and trading book. For liquidity and forex-exposure daily reporting is required. Temporary special ad hoc reporting is required upon the announcement of capital operations by the bank, in special circumstances[9] or when specific measures have been taken as part of economic policy.[10] Reporting is submitted electronically; it is subject to a number of (automated) internal consistency tests and to a (manual) test of probability (in order to check consistency over time). An automated analysis tool provides for standardized exploitation of reports and for delivering standardized analysis reports to offsite analysts. The lack of regular certification by banks' external auditors of prudential reporting and/or of the integrity and/or reliability of their reporting system is a weakness in the reporting process. There is no formal certification process for prudential reporting and its quality is thus only assessed at comprehensive inspections, such as on average once per two to three years. Although there are no shortcomings that raise concerns about the reliability of reporting,[11] the quality thus virtually untested over relatively long periods of time.
Assessment	*Largely Compliant*
Comments	The reporting regime is comprehensive and the exploitation systems within the NBS are adequate to ensure effective information gathering and analysis. It is however recommended that the NBS takes additional steps to ensure the reliability of reporting through more regular certification. This would require cooperation with external auditors (see BCP 17). The extent of reporting is sometimes criticized by banks as excessively burdensome, which is exacerbated by a perceived lack of consistency with international practices. The NBS could consider redesigning its reporting requirements along the lines of EU-practice[12], taking into account best practices in internal management reporting of Serbian banks. It should aim to minimize the additional reporting burden without losing content.
Principle 22.	**Accounting and disclosure.** Supervisors must be satisfied that each bank maintains adequate records drawn up in accordance with accounting policies and practices that are widely accepted internationally, and publishes, on a regular basis, information that fairly reflects its financial condition and profitability.
Description	Serbian accounting legislation has been brought in full compliance with IFRS standards. All banks are required to publish financial reports and additional information according to IFRS disclosure standards. The governing board is ultimately responsible for banks' annual reports and financial statements.

[9] E.g., when deposit outflow turned significant during the crisis
[10] E.g., limits on consumer lending
[11] It shall be noted however that on the application of loan classification regulation there appears to be a rather broad divergence in interpretation by banks and supervisors impacting on the quality of reports.
[12] Essentially FINREP and the core parts of COREP as recommended by CEBS.

	Annual reports are deposited at the NBS and are to be published on the banks' websites. Major banks publish their audited annual reports in the national press. A project is under finalization to entrust the deposit of reports to a unit at the Ministry of Economic Affairs and to enhance the publication obligations, as part of Basel II preparation (Pillar III). This could further improve access for the general public. Accounts of banks are audited and certified by external auditors, who need to be licensed to this effect by NBS. Besides the "Big 4" also a small number of local auditing firms is present in Serbia. The NBS approves the appointment of external auditors and can request banks to revoke their designation. NBS receives external auditors' reports. In extreme circumstances, the NBS may require them to perform specific verifications on its behalf. There is an obligation for banks to publish both qualitative and quantitative information on their risk exposure and/or risk management strategy according to IFRS. NBS publishes on a regular basis aggregate data on the banking sector and other segments of the financial sector, with the exception of securities brokers. The latter are, however, of limited significance as of today.
Assessment	*Largely compliant*
Comments	Disclosure requirements for banks should be further enhanced to bring them fully in line with international standards under Basel II. Furthermore an update of the NBS's instruction for bank accounting with a view on bringing it fully in line with international best practice is suggested. It is strongly recommended that the NBS discuss with the audit profession the issuing of a joint paper outlining the specific audit methodology for banks. The NBS and the audit profession could also explore modalities through which the contribution of the external auditors to the supervisory process can be enhanced, starting with their role in the periodical certification of banks' prudential reports and/or of their reporting processes.
Principle 23.	**Corrective and remedial powers of supervisors.** Supervisors must have at their disposal an adequate range of supervisory tools to bring about timely corrective actions. This includes the ability, where appropriate, to revoke the banking license or to recommend its revocation.
Description	The NBS has a wide spectrum of corrective actions at its disposal. The legal framework is defined in the Laws (Art. 110–120), bylaws and internal procedures. The framework consists of the following categories of corrective actions: (i) written warnings, (ii) ordering letters, (iii) a formal NBS Decision to eliminate irregularities, (iv) appointment of receiver and (v) removal of the license of the bank. The measures are further specified in the Decision on Detailed conditions and manners of conducting supervision by the National Bank of Serbia. Banks subject to corrective actions are obliged to report regularly to the NBS and deadlines are in force. The framework is in the process of being expanded, with enhanced responsibility and authority for receivers in the pipeline – including the capacity to impose a temporary moratorium. In addition, the NBS can impose temporary measures, which allows the NBS to react preemptively to observed irregularities, such as liquidity shortfalls. The NBS has the authority to impose fines, either on banks or on individuals within the banks (including members of management or the executive board). In practice, the NBS relies most on ordering letters. It has never used its right to withdraw licenses and only in one recent case a receiver was appointed. MOUs have been established with other relevant supervisors, but the NBS indicated that coordination should be strengthened in practice. This seems most relevant for home supervisors of parent banks (see BCP 25) and (domestically)

	the Securities Commission. In addition to the aforementioned corrective actions, the NBS has the authority to impose fines (Art. 137–141) and it can remove and suspend members of the Board of Directors and of the Executive Board (Art. 118) for failing to meet the requirements of the Law or for being responsible for irregularities. It may also order a bank to increase capital, restrict activities, rationalize the organizational structure or suspend the pay-out of dividends (Art. 116). In order to impose these measures, the NBS observes the principle of proportionality according to Art. 120. In choosing the particular corrective action, it also takes the responsiveness of management to corrective actions and the importance of the respective bank for the Serbian financial system in consideration (Art. 120). In applying its remedial powers, the NBS acts upon information made available through onsite inspections and offsite reporting. The NBS indicated that on average, around half of the onsite inspections results in some sort of formal corrective actions or sanctions, the latter being mostly fines. Proposed corrective and sanctioning measures and fines are submitted for approval to the SRC. A specific proposal is drafted by the Legal department upon approval by the SRC, which is subsequently submitted for approval to the vice-governor and is ultimately signed by the governor. On average, the procedure takes some two weeks. The “checks and balances” are deliberately built in to ensure objectivity and consistency in the application of the instruments, although the NBS indicated in the self-assessment that the procedure prevents the NBS from acting quickly in the face of observed irregularities.
Assessment	*Largely Compliant*
Comments	Main priorities are the strengthening of cooperation with other involved supervisors—both domestically and internationally—and ensuring that internal procedures do not prevent the NBS from acting speedily and decisively in the face of serious irregularities.
Principle 24.	**Consolidated supervision.** An essential element of banking supervision is that supervisors supervise the banking group on a consolidated basis, adequately monitoring and, as appropriate, applying prudential norms to all aspects of the business conducted by the group worldwide.
Description	The NBS not only supervises banks, but also leasing companies, insurance undertakings and pension funds. Following the enactment of the 2005 Law on Banks, the NBS conducts supervision of banking groups on a consolidated basis (Art. 122). It is therefore in a favorable position to conduct proper consolidated supervision over banking groups whose controlling entity is established in Serbia. Only for securities brokers is supervision entrusted to a separate authority, with which the NBS has a MOU on the exchange of information. Only one Serbian bank has established subsidiaries abroad and the NBS has concluded an MOU with the two host supervisors concerned. The NBS exerts due diligence with regard to shareholder-structures over banks, their transparency and their potential impact on supervision. Since Serbian banks are not authorized to acquire significant or controlling stakes in non-financial companies, NBS can be expected to have a comprehensive and clear overview on banking groups established within the country. In terms of financial reporting, Serbian law requires publication of consolidated statements on the basis of standards inspired by international practice. The possibility to exclude minor entities from consolidation and the very limited impact of subsidiaries on Serbian banks somewhat limits the impact of

	this requirement. Full consolidation of all entities is not yet generally practiced. There are no comprehensive supervisory requirements for reporting on a consolidated basis by banks nor does NBS exert a systematic analysis of consolidate risk positions, monitor global lending concentration or impose consolidated capital requirements[13]. Strengthening of consolidated reported requirements would also improve the NBS's capacity to enforce compliance with large exposure limits (BCP 10) and related party exposures (BCP 11).
Assessment	*Materially non compliant*
Comments	The NBS is recommended to require proper reporting on a consolidated basis for all key elements of banking groups financial position: CAR, risk measurement, provisioning, risk concentration. It also needs to establish, within the offsite division of BS, procedures for adequate analysis and management reporting on the position and results of banks on a consolidated basis
Principle 25.	**Home-host relationships.** Cross-border consolidated supervision requires cooperation and information exchange between home supervisors and the various other supervisors involved, primarily host banking supervisors. Banking supervisors must require the local operations of foreign banks to be conducted to the same standards as those required of domestic institutions.
Description	The majority of Serbian banks are foreign-owned and most of them are part of EU banking groups. All are subsidiaries, as Serbia does not allow the establishment of branches by foreign banks. Only one Serbian bank has established subsidiaries abroad, in two neighboring countries, and no branches have been created by Serbian banks abroad. The NBS has signed bilateral MOU agreements with the banking supervisors of most countries in the region. However, MOU negotiations with three EU home supervisors (France, Germany, and Austria) for a number of significant banks operating in Serbia have been on hold for quite a while. The obligation of the NBS to share information with the Serbian tax authority is the main impediment and raises confidentiality concerns on behalf of the home supervisors. This obligation, enshrined in an MOU, obliges the NBS to disseminate information, both on banks' proprietary situation and operations and on the accounts of individual customers, to the national tax authorities and thus goes beyond what is internationally accepted under privacy protection laws. The NBS proactively participates in supervisory colleges, as these are designed and created under EU-regulation for large international groups. It effectively contributes to and benefits from exchange of the information trough these colleges. The timeliness and scope of the process varies, however, from one home supervisor to the other. NBS takes an active stance in such colleges, even if the Serbian establishments concerned do not significantly impact on the group level. Home supervisors invite parent banks of larger groups to present their consolidated position and strategy to the college, which creates an opportunity for host supervisors to discuss directly and jointly with parents of the bank in question. NBS is at present also actively involved in the negotiations on multilateral MOU's, as these are under preparation essentially between EU countries with a view on enhancing supervisory cooperation on the supervision of cross-border banking groups. It hopes to sign such MOUs in the near future.

[13] Banks which could be subject to consolidated supervision have as of today very comfortable capital buffers and that the main subsidiaries (leasing companies) are under NBS' supervision on a solo-basis.

	The Serbian banking law provides for flexible access for home supervisors to Serbian banks for both information gathering and onsite inspection. The NBS informs the relevant home supervisors on an ad hoc basis of its intention to perform onsite inspections at foreign subsidiaries and notifies the home supervisor of the scope and subject of the inspection. Although the NBS does not actively invite foreign supervisors, it has a positive view on accepting their participation in joint inspections. So far about three joint onsite inspections have been performed. NBS considers these experiences mutually beneficial. In one experience cooperation with Slovenian authorities allowed an NBS-onsite team to leverage on IT-expertise, which at present is not available within BSD. Although no such joint onsite inspections have been performed for the Serbian bank with foreign subsidiaries, the NBS also strives to do so in the near future.
Assessment	*Materially non compliant*
Comments	Although the NBS is prevented from signing MOU's with three EU supervisors due to its obligations on domestic exchange of information with the tax authorities, ad hoc arrangements have been agreed allowing for effective cooperation with two of them. Nevertheless, the legal provision on cooperation in fiscal matters needs to be revisited in order to allow NBS to duly formalize these arrangements under an MOU agreement. The absence of MOU agreements affects the NBS's potential to establish due cooperation with all relevant supervisors. The NBS is encouraged to further contribute to the enhancement of the information exchange process with all relevant home supervisors. The NBS may provide their counterparty supervisors the opportunity to conduct inspection of the local subsidiaries, and by offering relevant information on a regular basis, such as on the basis of the periodical internal reporting. Moreover, taking the initiative to establish direct contact, including telephone conversation for informally exchanging information can also contribute to promote a more open climate of cooperation. This can e.g. be considered on the basis of the periodical analysis of banks' financial position and by exchanging the main findings of onsite inspections. A proportionate practice could contribute to enhance mutual trust and create a favorable climate for more open communication. The beneficial effects of joint inspections can potentially be enhanced by not only informing home supervisors of envisaged onsite work on an ad hoc basis, but by communicating at an early stage relevant information on NBS' inspection planning or even inviting them to have a consultative voice therein.