

Based on Article 45, paragraph 1. of the Law on the Government (“Official Gazette of the Republic of Serbia”, Nos. 55/05, 71/05-correction, 101/07, 65/08, 16/11, 68/12-constitutional court, 72/12, 7/14-constitutional court and 44/14),

The Government hereby issues the

NPL Resolution Strategy

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INTRODUCTION

High and rising level of non-performing loans (hereafter: NPLs) became a source of systemic risk not only in Republic of Serbia, but also in other emerging and some developed economies. In many countries NPLs reached the levels that are negatively affecting credit supply channel and are causing worsening of the banking sector financial soundness indicators. In this respect, cleaning banking sector balance sheet became an imperative for new lending activity at lower interest rates and for supporting economy to achieve sustainable growth rates. Analyses made by International Financial Institutions (hereafter: IFIs) are implying that the NPLs ratio higher than 10% leads to a credit growth lower by 4% (excluding secondary effects). Therefore, NPLs should be resolved in a sustainable manner, to ensure that the banking sector is fully capable to revitalize lending activity to economically viable companies.

Banking sector in Republic of Serbia is well-capitalized and liquid. Share of NPL in total loans is high, but they are still not jeopardizing financial system stability as they are fully provisioned. Nevertheless, they became source of systemic risk, and Republic of Serbia authorities (the Government of the Republic of Serbia and the National Bank of Serbia) recognized NPLs resolution as task of high priority that calls for the comprehensive strategy, with the involvement of all relevant stakeholders. The Government has formed a special Working Group consisted of representatives of all relevant authorities to streamline the process of drafting the Strategy for NPLs resolution (hereafter: Strategy), which will include: (i) identification of legal, tax, institutional and other impediments that prevent resolution of NPLs, (ii) range of specific actions (policies and measures) to be taken by each institution in order to achieve general goal and key priorities of the Strategy, (iii) a Government action plan covering the activities of all government institutions and NBS' action plan containing all the activities the NBS will carry out for the implementation of the Strategy, and (iv) follow-up obligation for the Working Group and all institutions in charge of undertaking these activities.

In accordance with this Strategy, competent institutions shall carry out number of activities, as needed to: (i) assess banks' capacity to deal with NPLs, (ii) enable conditions for NPL market development, (iii) improve and promote out-of-court restructuring, and (iv) improve in-court corporate debt resolution mechanisms and mortgage framework.

I NPL OVERVIEW

Non-performing loan is defined by Decision on Reporting Requirements for Banks (RS Official Gazette, Nos 125/2014 and 4/2015) – Schedule 8 (NPL 1), as the total outstanding debt under an individual loan (including the amount of arrears):

– where the payment of principal or interest is past due (within the meaning of the decision on classification of balance sheet assets and off-balance sheet items) over 90 days,

– where at least three months of interest payments have been added to the loan balance, capitalized, refinanced or delayed by agreement,

– where payments are less than 90 days overdue, but the bank has assessed that the borrower's repayment ability has deteriorated and doubts that the payments will be made in full.

1.1. NPL Level and structure

Banking sector of the Republic of Serbia is highly capitalized. Capital adequacy ratio for the banking sector at the end of March 2015 was at the level of 20.25%, which is sufficiently above

regulatory minimum in Serbia (12%) and considerably above the international standard set by Basel Committee on Banking Supervision (8%). Average liquidity ratio in March 2015 was 2.21 (regulatory minimum is 1.0) and was above 2.0 during most of the year 2014 and in the first quarter of 2015, indicating that liquid assets (first-degree and maturing in the next 30 days) were twice as large as sum of liabilities without maturity and liabilities maturing within 30 days. In the pre-crisis period and even few years after the crises had hit (2006-2010), banking sector made relatively stable profit, but in the last four years (from 2011 ahead) profitability of banking sector was mostly driven by outliers. It should be noted that delicensing of four banks and significant increase in the level of allowances for impairment for one bank mainly contributed to decrease of banking sector profitability in the previous period.

Still, non-performing loans are the main issue in the Serbian banking sector. The level, structure and the nature of non-performing loans represent significant source of risk for banking operations, wherein main causes of generation and increase of non-performing loans point to the necessity of comprehensive and strategic approach regarding their resolution. In addition, accumulation of non-performing loans in banks' balance sheets produce negative impact on lending activities and therefore on economic activities as well, primarily due to the decrease of availability of potential source of funding both for the enterprises and for the population.

High and rising levels of NPLs make pressure on banks' balance sheets. Since the beginning of the financial crisis, when the NBS started their regular monitoring (2008), the NPLs in Serbian banking sector have recorded more or less continuous growth. After a temporary decrease in the second half of 2012 (which was mostly due to de-licensing of Agrobanka), NPLs rose again in 2013 and continued to grow in 2014 and in the first quarter of 2015. At the end of April 2015, NPLs in the Serbian banking sector reached RSD 442.6 billion (EUR 3.7 billion) with gross NPL ratio of 23.0%.

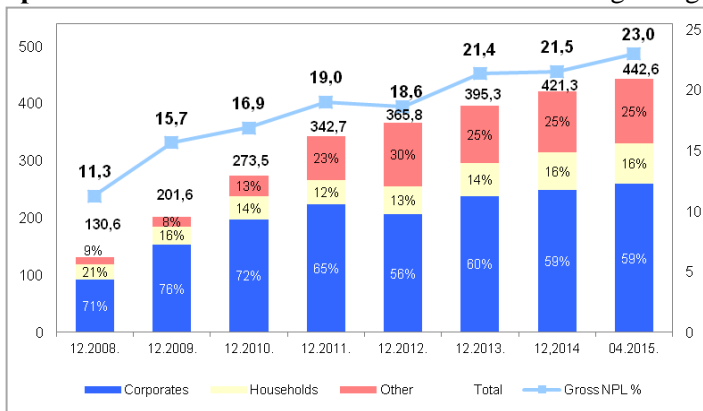


Chart 1. Gross non-performing loans (NPL), RSD bln.

The sector of privately-owned enterprises determines the overall NPLs, both in terms of its volume and its relative share in total loans. The share of privately-owned corporate sector NPLs in total outstanding NPLs at the end of April 2015 was 52.5% (RSD 232.2 billion), with the NPL ratio of 28.8%. Construction, which accounts for 16.2% of total privately-owned corporate sector NPLs, had the highest NPL ratio in corporate sector of 50.4% and is followed by manufacturing (accounts for 32.8% with gross NPL ratio of 26.5%) and trade (accounts for 28.1% with gross NPL ratio of 25.4%). It should be emphasized that entities under bankruptcy procedure (which are disclosed separately from “active” enterprises for statistical purposes) account for app. 20% of total NPLs. The NPL of public enterprises¹ accounts for 6.1% (RSD 27 billion) of total NPLs at the end of April 2015 with gross NPL ratio of 15.6%.

¹ Public enterprises are enterprises which perform activities of public interest and which are founded by the Republic of Serbia, by an autonomous province or by a local government unit (The sectorial classification of institutional units according to the European System of Accounts (ESA 2010) is used exclusively in order to develop statistical reports which are delivered to the NBS).

Chart 2: NPLs trend – total and by sector

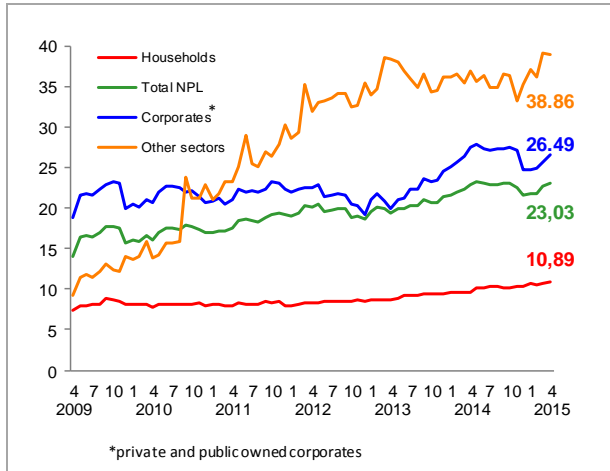
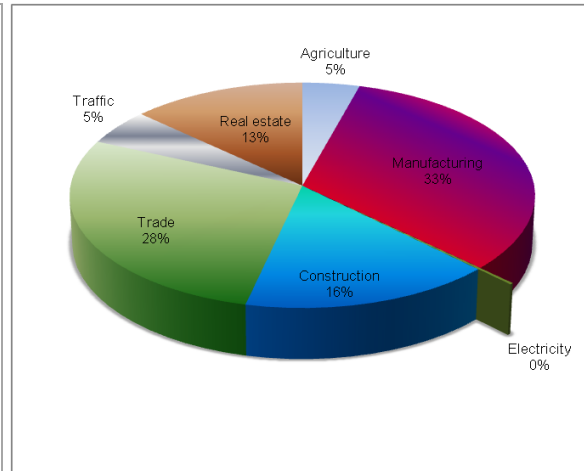


Chart 3: NPLs of corporates by sector



Nonperforming loans of households’ continuously grow. Households’ non-performing loans comprise 16.1% (RSD 71 billion) of total non-performing loans outstanding. The NPL ratio for households exceeded 10% for the first time in May 2014 and at the end of April 2015 it has already reached 10.9%. Mortgage loans had gross NPL ratio of 9.0% at the end of April 2015. The deterioration of mortgage loans in the previous period was primarily driven by a significant increase in the unemployment rate, stagnation of salaries and Dinar depreciation. Nevertheless, NPL ratio for households remains well below the average for total loans and significantly below NPL ratio for corporate sector.

Most of the NPLs refer to loans overdue for more than one year. Compared with end 2013, share of NPLs one year past due increased from 64% to 73% at the end of April 2015. Namely, RSD 322 billion of NPLs refer to loans overdue for more than 365 days, out of which 236 billion RSD refers to loans which are overdue for more than two years. Along with the increase of total gross NPLs (compared with end 2013) by 12%, total amount of NPLs overdue for more than one year increased by 26%. In addition, 74% of total NPLs of corporates in insolvency (66 billion RSD) refer to loans which are overdue for more than two years. Maturity structure of NPL portfolio reflects numerous issues banks are facing in the process of collection and in the course of bankruptcy procedures attempting to resolve NPLs.

Chart 4: NPL coverage (%)

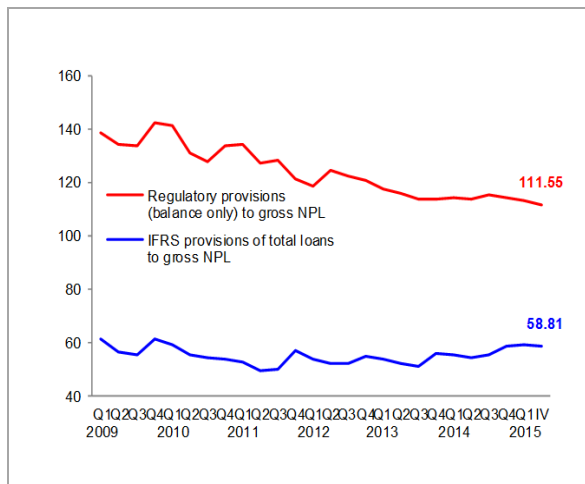
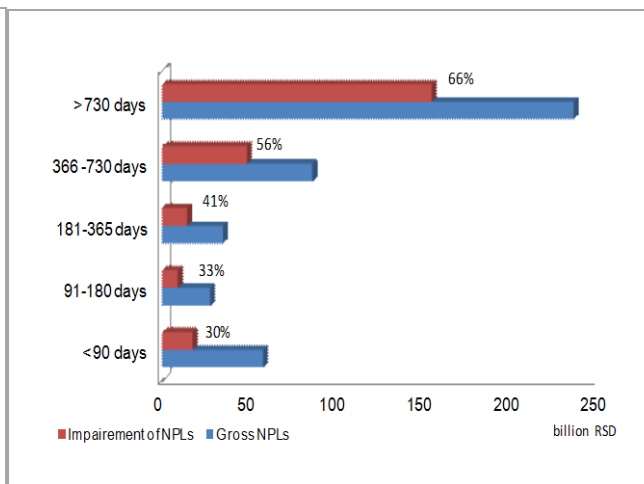


Chart 5: IFRS coverage of NPL by days past due



Non-performing loans are considerably covered in terms of regulatory provisions (112%) and to a certain extent in terms of IFRS allowance for impairments (59%). Particularly, level of IFRS allowance for impairment for NPLs with longer past due periods, especially when it comes to corporate sector, reflects issues regarding adequacy of banking sector provisioning practices and quality of collateral valuation as well. Determining whether current level of IFRS coverage with allowances for impairment is adequate requires further analyses and deeper insight into procedures and practices banks are applying regarding provisioning.

Table 1: Coverage of NPLs with IFRS allowances for impairment

30.04.2015.	< 90 days	91-180 days	181-365 days	366-730 days	>730 days
Corporate sector	33%	31%	36%	52%	53%
Corporate in bankruptcy	57%	82%	64%	68%	77%
Retail sector	22%	27%	48%	66%	75%
Total	30%	33%	41%	56%	66%

1.2. Reasons behind high NPL level in Serbia

Many emerging economies, including Republic of Serbia, were having high credit growth rates before the crisis hit. Republic of Serbia in 2005 and 2006 saw a credit expansion that was mainly driven by the arrival of the so-called “foreign-owned” banks that brought cheaper sources of funding. With the aim to prevent negative effects to monetary and financial stability arising from strong credit expansion, which resulted in a high loan euroisation in Republic of Serbia, the National Bank of Serbia imposed countercyclical measures.

Chart 6: Real lending to corporates and households (y-o-y rates, in %)

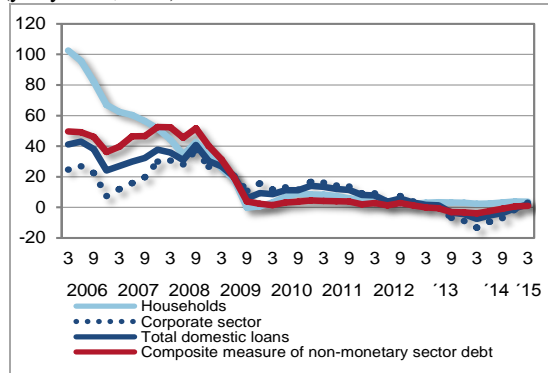
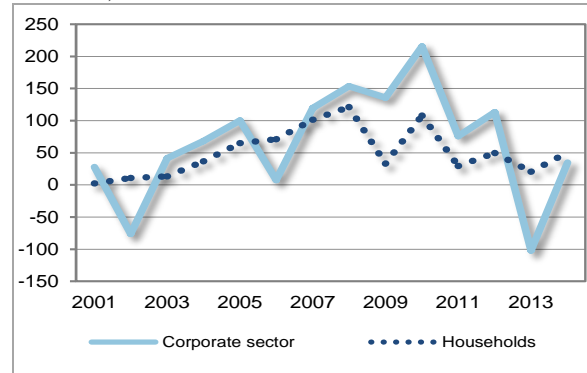


Chart 7: Nominal growth of lending corporates and households (in RSD bln)



Period from 2005 to 2008 saw improvements of key macroeconomic indicators, but, at the same time, current account deficit reached its peaks (it widened from 8.4% to 21.1% of GDP). This was a clear sign that the period of consumer-based growth model is not sustainable in the long-run, and should be replaced by investment and export based model of growth.

Table 2: Macroeconomics indicators

	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	Q1 2015
Real GDP growth (in %) ¹⁾	5.5	4.9	5.9	5.4	-3.1	0.6	1.4	-1.0	2.6	-1.8	-1.8
Consumer prices (in %, relative to the same month a year earlier) ²⁾	17.7	6.6	11.0	8.6	6.6	10.3	7.0	12.2	2.2	1.7	1.9
NBS foreign exchange reserves (in EUR million)	4,922	9,020	9,634	8,162	10,602	10,002	12,058	10,915	11,189	9,907	10,515
Exports (in EUR million) ³⁾	5,329	6,948	8,110	9,583	8,043	9,515	11,145	11,469	13,937	14,451	3,531
- growth rate in % compared to a year earlier	19.1	30.4	-	18.2	-16.1	18.3	17.1	2.9	21.5	3.7	6.9
Imports (in EUR million) ³⁾	9,612	11,970	15,468	18,267	13,099	14,244	16,487	16,992	17,782	18,096	4,434
- growth rate in % compared to a year earlier	0.7	24.5	-	18.1	-28.3	8.7	15.7	3.1	4.7	1.8	7.1
Current account balance (in EUR mln) ³⁾	-1,778	-2,356	-5,474	-7,126	-2,032	-2,037	-3,656	-3,671	-2,098	-1,985	-447
as % of GDP	-8.4	-9.6	-18.6	-21.1	-6.6	-6.8	-10.9	-11.6	-6.1	-6.0	-6.2
Unemployment according to the Survey (in %)	20.8	20.9	18.1	13.6	16.1	19.2	23.0	23.9	22.1	18.9	19.2
Wages (average for the period, in EUR)	209.7	260.0	347.1	400.5	337.4	330.1	372.5	364.5	388.6	379.3	344.0
RS budget deficit/surplus (in % of GDP) ⁴⁾	0.5	-1.7	-1.6	-1.7	-3.2	-3.4	-4.0	-5.9	-5.2	-6.4	-2.4
Consolidated fiscal result (in % of GDP) ⁴⁾	1.2	-1.5	-1.9	-2.6	-4.4	-4.6	-4.8	-6.8	-5.5	-6.7	-2.4
RS public debt, (central government, in % of GDP)	50.2	35.9	29.9	28.3	32.8	41.8	45.4	56.2	59.6	71.0	75.1
RSD/EUR exchange rate (end of period)	85.50	79.00	79.24	88.60	95.89	105.50	104.64	113.72	114.64	120.96	120.22

¹⁾ At constant prices of previous year.
²⁾ Retail prices until 2006.
³⁾ Starting from 2007 data on exports and imports of goods and services are shown in accordance with BPM6. Data for 2005 and 2006 are shown according to BPM5. Due to series discontinuation, exports and imports growth rates for the year 2007 have not been displayed. Since January 1st 2010 the Statistical Office registers exports and imports according to the general trade system, which represents a broader concept and encompasses all goods and services that enter or exit the economic territory of the Republic, with the exception of goods in transit. The Statistical Office has published comparable data for years 2007, 2008 and 2009. Previous years are displayed according to the special trade system. Exchange of goods with Montenegro has been registered according to belonging transactions since 2003.
⁴⁾ Includes below-the-line items (payment of called guarantees, bank recapitalisations and debt takeover) in line with IMF methodology, as of 2008 on RS budget level and as of 2005 on consolidated level.
Source: Statistical Office, MoF, NBS.

Strong credit growth was based on less conservative credit risk models and poor collateral valuation. As a result, Republic of Serbia entered the crisis with a high NPL ratio of 11.3% at the end of 2008. The sharp increase occurred a year after, with the outbreak of the financial crisis, when macroeconomic conditions in Republic of Serbia deteriorated sharply, as well as in other emerging economies. During 2009, the NPL ratio rose by 4.4 p.p. to 15.7%, led by surge in NPLs of corporate sector.

Chart 8: NPL and macroeconomic indicators, monthly

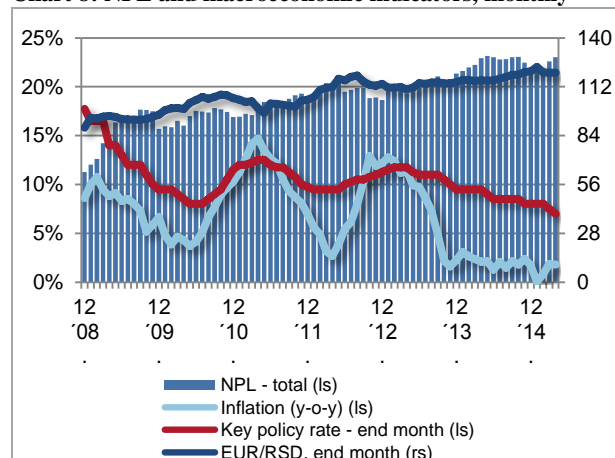
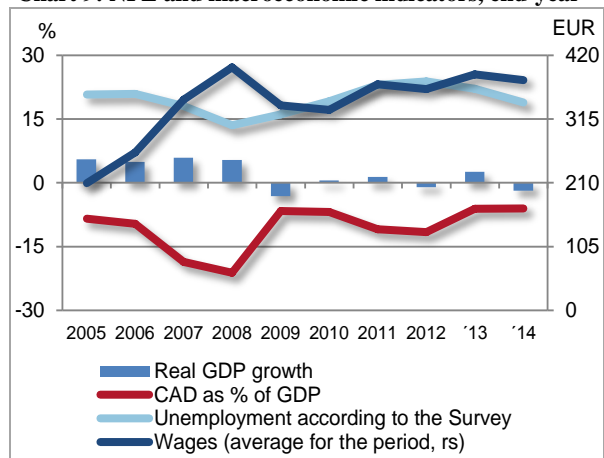


Chart 9: NPL and macroeconomic indicators, end-year



Analyses conducted by many institutions, domestic and international, are confirming that the rising trend in NPLs that occurred in the period after 2009 is a consequence of both macroeconomic and bank-specific factors. Among the macroeconomic determinants, econometric analyses are confirming that higher unemployment rate, exchange rate depreciation and higher inflation are contributing to higher NPLs, while NPLs are showing negative correlation with the pace of economic recovery (higher GDP growth results in lower NPL ratio). In 2009, Republic of Serbia GDP growth rate was -3.1%. The period 2010 – 2014 saw much lower GDP growth rates compared to pre-crisis period, ranging from -1.8% to 2.6%. The upward trend in NPLs after 2008 is also the consequence of rising unemployment rate – up from 13.6% at the end of 2008 to 18.9% at the end of 2014 (based on Labor Force Survey data). In addition, dinar’s depreciation against euro by 22.1% cumulative in 2009 – 2012 also contributed to the rise of NPLs. High and persistent loan euroisation (around 70%) makes un-hedged corporates and households more vulnerable to the exchange rate depreciation. As a result, negative and then sluggish economic activity, combined with rising unemployment, local currency depreciation and drop in real wages, weakened the borrowers repayment capacity and caused NPLs to rise during 2009 - 2012. Thereafter the NPLs’ rose at a much slower pace..

Apart from macroeconomic factors that contributed to the rise in NPLs, there are also bank-specific factors that are slowing down resolution of NPL portfolios. Although credit standards are much tighter nowadays compared to pre-crisis period, banks still have to improve their capacity to manage NPL portfolios. The evidence of banks’ operational capabilities in the area of NPL management shows that some banks are faced with weak internal organization and poor analytical capacity, without clear processes and procedures for NPL management, which is important for their effective resolution. This is transferred in high share of NPLs that are overdue for more than 365 days (73% at the end of April 2015).

Slow resolution of NPL stock can also be attributed to undeveloped market for NPLs. One of the reasons behind under-developed NPL market can be found on the supply side. Banks are unwilling to sell loans because of high discounts, partly caused by inadequate collateral valuation that does not necessarily follow international best practices. Thus, estimating future cash flows from loans backed by collateral pose a challenge and impede sale of NPLs. In addition, information asymmetries, weaknesses in the enforcement of secured creditor rights, costly and lengthy enforcement and insolvency court proceedings, are negatively affecting market for NPLs.

1.2.1. Macroeconomic challenges with negative impact on NPL level – domestic and international

Economic recovery continues, but still faces some challenges. After negative rate in 2014, real GDP is expected to exhibit mild recovery in 2015. The somewhat better economic activity than projected at the beginning of 2015 reflects the effects of lower oil prices on domestic demand and a more favorable external environment. Despite sizeable fiscal consolidation, the decline of domestic demand will be limited and offset by stronger external demand. Growth is projected to gradually accelerate over the medium term on account of smaller fiscal adjustment, recovering market confidence and credit growth, and positive effects of structural reforms.

Headline inflation (measured by the annual change in the CPI) is projected to return close to the inflation target of $4\% \pm 1.5$ p.p. by the end of 2015 and remain within the tolerance band thereafter. As the fiscal adjustment and external financing conditions stabilize, key policy rate was reduced to 6% (which is its lowest level), in line with the inflation outlook and financial stability. Further easing will be gradual and will depend on macroeconomic environment, including external financing conditions.

The Government is committed to implementing a set of fiscal consolidation policies that will reverse the rise in public debt by 2017 and put it firmly on a downward path thereafter. A credible three-year adjustment with significant front-loading was introduced with gross fiscal measures amounting to $4\frac{3}{4}$ percent of GDP during 2015–17, of which over half has already been implemented or will be implemented in 2015. The measures focus primarily on containing public expenditures.

The current account deficit is expected to further decline, from 6.0% of GDP in 2014 to 4.25% of GDP in 2015, and then to decrease further to close to 3.5% of GDP over the medium term. External financing is expected to rely mostly on FDI, Eurobond issuance and project loans, with some possibility of another bilateral concessional loan.

There are some downside exogenous risks, but there are considerable buffers to withstand them. Possible spillovers from regional developments and a protracted period of slow growth in trading partners could have a negative impact on Serbia. Continued deleveraging by foreign bank subsidiaries, which dominate Serbian financial sector (around 75.0% of banking sector assets refers to the so-called “foreign- owned” banks), could pose challenges. However, measured by all relevant indicators, foreign exchange reserves are high enough to safeguard domestic system from external shocks. Banking system as a whole is well-capitalized and liquid, domestic deposit base is strong, while the arrangement with the IMF provides an additional buffer to cope with negative shocks.

High level of credit (around 70.0%) and deposit (around 77%) euroisation remains one of downside risks. To this end, the National bank of Serbia and the Government will continue to implement dinarization strategy based on three pillars: (i) maintaining overall macroeconomic stability; (ii) creating favorable conditions for developing the dinar bond market; and (iii) promoting hedging instruments against exchange rate risks. Recognizing the risks coming from high level of euroisation on monetary and financial stability, the National bank of Serbia will maintain the existing managed float exchange rate regime which is in line with the Inflation targeting framework. Therefore, the National bank of Serbia interventions at the Foreign Exchange Interbank Market will continue to be limited to smoothing excessive exchange rate volatility without targeting a specific level or path for the exchange rate, while considering the implications for financial system stability and meeting the inflation target.

1.3. Activities taken so far in combating NPL

The National bank of Serbia imposed measures in order to limit foreign currency lending to un-hedged borrowers and designed monetary policy instruments to be supportive for the

dinarization of the Serbian financial system. One of the causes of rising NPLs with the outbreak of the financial crisis, in highly euroised economy, was local currency depreciation. The roots of euroisation in the Republic of Serbia are quite deep and are a consequence of a period of hyperinflation during the 1990s. High level of credit euroisation (around 70%) is one of the systemic risks, because currency depreciation weakens repayment capacity of un-hedged borrowers. At the same time, high level of credit euroisation in Serbia is impairing the efficiency of monetary transmission channel, as key policy rate change is affecting just 30% of credit market. Therefore de-euroisation is a systemically important task, but also a long-term process which requires joint efforts of all relevant Serbian authorities. In this respect, the National bank of Serbia and the Government of the Republic of Serbia jointly defined the Dinarization Strategy and committed to its implementation. Many measures and activities were implemented so far: much lower required reserve ratios on the portion of the dinar base (5% and 0%, compared to 26% and 19% on the portion of the foreign currency base, depending on sources of funding maturities); borrowing in dinars by the IFIs is liberalized; sole use of dinar denominated securities within the monetary operations, including the dinar denominated securities issued by top-rated IFIs; foreign exchange swaps lines are introduced with the aim to promote foreign exchange hedging market; dinar yield curve is extended to 10-years through successful placement of a 10-year dinar denominated T-bond. In order to reduce building-up of foreign exchange risk in the system, in mid-2011 several prudential measures were also introduced: foreign exchange loans to individuals were prohibited, except in euros (or euro-linked); 80% LTV (loan-to-value) ratio for foreign exchange and foreign exchange-linked housing loans was introduced; mandatory 30% down-payment for all foreign exchange and foreign exchange-linked loans to individuals was imposed. Implementation of those measures contributed to increase in dinar lending to households – up from 21.6% in January 2010 to 41.2% in May 2015. Overall level of loan dinarization is still low (30.1%) due to low level of dinar lending to corporate sector (although policy of subsidized credit programme in dinars was supportive for the dinarization of corporate loans that grew from 18.6% at the end of May 2014 to 22.5% at the end of May 2015, it is still very low).

Inflation is lowered, inflation expectations are anchored, interest rates on dinar loans decreased while the dinar exchange rate became more stable. Y-o-Y inflation entered the tolerance band in September 2013 and fell below lower bound of the tolerance band in March 2014. Inflation expectations which have been stable within the target tolerance band for more than a year are also indicating that no major inflationary pressures are expected in the period ahead. The key policy rate was cut in June 2015 to 6% – its lowest level since the introduction of the Inflation Targeting Regime. Led by the fall in key policy rate, interest rates on dinar loans fell too. Despite many external risks, relative stability of dinar exchange rate is achieved as of Q4 2012, supported by the National bank of Serbia measures. Due to achieved stability, the exchange rate depreciation had a lower contribution to the NPLs movements in the period after 2012 compared to real wages.

The Serbian authorities, with assistance from the IFIs, participated in a range of initiatives to support debt resolution. Initiatives include projects on improvements of insolvency frameworks and the regime for consensual out-of-court restructuring; judicial capacity building; development of a database of real estate collateral valuations; development of proper valuation standards and a robust oversight framework for real estate appraisers. In parallel, Serbian authorities actively participated in international forums, like Vienna and Belgrade Initiative, and have active cooperation with banking groups and home supervisors in order to consider parent banks' plans and capacity for further financing their subsidiaries, as well as to secure financial support to domestic banking sector.

Conference “Belgrade Initiative – Resolution of Non-Performing Loans in Serbia”

In late April 2015, a two-day conference “Belgrade Initiative – Resolution of Non-Performing Loans in Serbia” gathered a number of representatives of the private and public sectors and international financial institutions. It was organized in cooperation with the NBS, Ministry of Finance, World Bank Financial Services Advisory Centre (Fin SAC) and International Monetary Fund. Around 150 representatives of competent ministries, banks, international financial institutions, Association of Serbian Banks, domestic and foreign audit firms, investors and lawyers took part.

The main observations and conclusions from the Conference are:

- The NPL resolution is a burning issue and activities to be taken by public sector representatives must be coordinated. Namely, any isolated solution would not ensure comprehensive and long-term NPL resolution. One of the key messages is that coordinated action of all competent institutions is crucial;
- Macroeconomic and fiscal consolidation, whose effects are already palpable, will contribute to faster NPL resolution. Aware that resolving this issue cannot be either fast or simple, participants agreed that efforts must be directed at solutions applicable to all cases. Therefore, a thorough analysis of root causes and identification of all obstacles and bottlenecks is essential so as to preclude any fallout. Besides, the NPL resolution must be practicable and economically sustainable;
- NPL resolution must be financed by the private sector, whereas the public sector must provide support through regulatory incentives. Private sector representatives confirmed that numerous regulatory solutions have already been adopted but have not been implemented, which is why they need to be promoted;
- Public and private sector representatives agreed that special diagnostic studies of banks, carried out by the NBS in cooperation with the IMF, and following the methodology comparable with that of the ECB, will help better identify issues relating to NPLs;
- Improvement of conditions for distressed debt market development is desirable through assessment of remaining impediments for the development of this market (tax, regulatory, accounting, data etc.);
- Pricing gap problem should be assessed – there are numerous factors which contribute to the pricing gap (illiquidity of the market, volume of the market, transparency of information, high fixed costs, lack of interested investors, level of provisioning, lack of willingness of banks to sell NPL, complicated enforcement procedures etc.);
- Tax incentives for write down of NPLs exist but it is important to remove obstacles for their full implementation in practice;
- The Property Valuation Law should be adopted in order to improve collateral valuation standards (it should regulate conditions for real estate valuation, licensing of appraisers, supervision of the process, Association of appraisers etc.);
- Real estate collateral valuation database will be developed in order to enable appraisers, banks and NBS to have access to relevant data regarding real estate values – in addition, NBS will use these data for the monitoring of risk developments in the financial system;
- Mortgage Law should be amended in order to enhance the process of out-of-court foreclosure of mortgaged property (enable the striking off of the rights of subsequent mortgagees in case of out-of-court selling of mortgaged property);
- Enhancing Insolvency regulatory framework by providing safeguards for secured creditors both in pre-pack and bankruptcy procedure;
- Capacity building of the Bankruptcy Administrators, Bankruptcy Judges and relevant stakeholders in order to improve effectiveness of bankruptcy procedure;
- Improve and promote the Law on Consensual Financial Restructuring of Companies;
- It is important to be part of “Collective action on regional level” (Vienna Initiative) - region-wide approach with country-specific work and solutions;
- the NPL resolution should result only from coordination of all stakeholders, which is why a comprehensive NPL resolution strategy has to be drawn up.

In order to preserve the stability of the banking sector, the National Bank of Serbia has adopted several counter-cyclical regulatory measures, whose effective implementation was possible due to the existence of considerable reserves accumulated during the pre-crisis period:

- Amendments to the Decision on Risk Management by Banks from December 2012 allowed banks to mitigate credit risk through assigning matured receivables from a legal person or an entrepreneur to another legal entity. This is a critical improvement due to the fact that, up to the adoption of these changes, the assignment of receivables was governed by very strict rules
- Amendments to the Decision on the Classification of Bank Balance Sheet Assets and Off-Balance Sheet Items from December 2012 also aimed at contributing to the resolution of NPLs, by providing an incentive for banks to invest additional efforts in employing existing legal mechanisms, i.e. the Law on Consensual Financial Restructuring of Companies and Bankruptcy Law
- NBS Executive Board at the end of 2014 adopted amendments and supplements to the Decision on the Classification of Bank Balance Sheet Assets and Off-Balance Sheet Items. The changes relate to the rules on the classification of assets acquired through collection of receivables, receivables from assignees, and the calculation of past due days as of the subsequently agreed maturity date.

These measures aimed at tackling the problem of non-performing loans and consequently, releasing funds previously blocked for creation of loan loss provisions in order to encourage lending to good projects and clients (with a positive effect on the real sector), gave their first effects which were, albeit, modest. Total receivables sold by banks, in period 2013-2015, amounted to only 56 billion RSD. Few banks took advantage of the opportunity to sell troubled loans to other private entities and in such way clean their portfolio and use these funds for lending in new and healthy projects.

Chart 5: Assigned corporate receivables by assignee 2013-2015

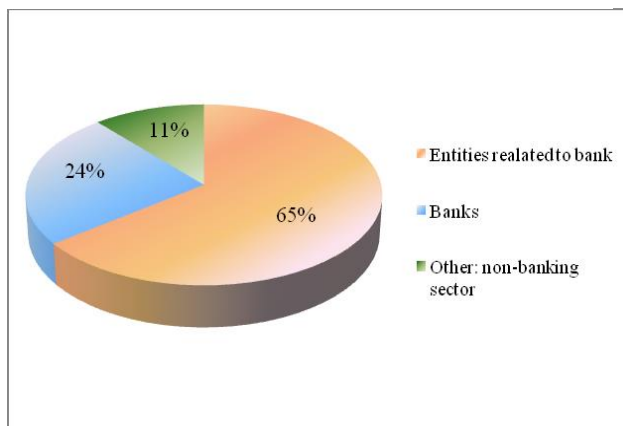
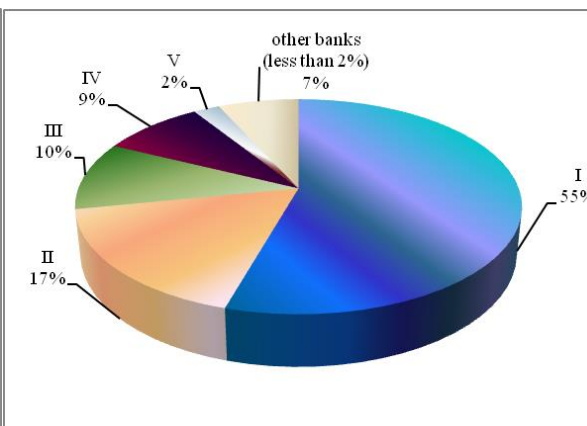


Chart 6: Share in total assigned corporate receivables by bank – top 5 banks 2013-2015



In March 2014, the NBS created a plan for NPL resolution. In the mentioned plan one of the short term measures, to be taken by the NBS with the aim of resolving the problem of high level of NPLs, was the analysis of the possibility of introducing mandatory write-off of NPLs, through a comparative analysis of the introduced measures in the region, as well as through the quantitative analysis of the effect this measure would produce on NPL ratio, income, or loss of individual banks, as well as whole banking sector.

Based on the results of the analysis, certain conclusions were made. It was concluded that introduction of mandatory direct write off model which prescribes that banks are obliged to write off unsecured corporate sector NPLs where the borrower is more than three years in arrears, secured corporate sector NPLs where the borrower is more than five years in arrears, as well as unsecured NPLs from the debtor in bankruptcy where the borrower is more than one year in arrears, would lead to:

- NPL ratio decrease by 4.88 percentage points;
- Losses for the entire banking sector amounting to 27.38 RSD billion (leading to transforming banking sector overall profits of 11.24 RSD billion as at 30 April 2014 into an overall loss of 16.14 RSD billion).

In April 2015, NBS prepared and sent to banks a comprehensive survey, with the aim to gather all relevant information regarding reasons for accumulation of NPLs in bank's balance sheets, impediments banks are facing in the process of trying to resolve NPLs (legal and practical obstacles) and measures banks are prepared to take if NPLs would have had severe impact on their liquidity or capital positions. The answers that the banks provided to NBS are being analyzed and results will be used in the process of determining future actions regarding the issues within the NBS competence.

The financial sector agenda agreed in MEFP is built around several pillars with diagnostics of banks' balance sheets being one of the fundamental. In view of the current uncertain economic environment, National Bank of Serbia is currently undertaking a program of special diagnostic studies (SDS) of banks operating in the Republic of Serbia, in line with similar initiatives in many EU countries. The diagnostic studies commenced in April 2015 and will be completed by end-September 2015.

These diagnostic studies, largely similar to asset quality reviews conducted in EU countries, will help verify the health of the banking system, dispel uncertainty about banks' asset quality and guide regulatory and supervisory policies. By specific design of the SDS, intention of the NBS is to shed more light on banks' collateral valuation practices, assessment of the adequacy of provisioning (particularly focusing on the aspect of proper IFRS application) and providing better information for combating vulnerabilities. In parallel, the NBS will further enhance supervisory and regulatory frameworks by leveraging standards and requirements contained in the EU's Single Rule Book, international best practices and the insights drawn from the diagnostic studies.

NBS will use the studies to foster conservative implementation of IFRS accounting standards and disclosure practices and in addition diagnostics will be guided, to the extent possible, by strengthened collateral valuation standards and minimum requirements for appraisers. Moreover, NBS will use the experiences obtained through this exercise to strengthen its prudential framework and supervisory approach.

1.4. Reasoning on the need to introduce a comprehensive NPL Strategy

In general, there are micro and macro prudential aspects to resolving the issue of NPLs. From the micro-prudential perspective, it is in the banks' interest to reduce the amount and number of NPLs, as it protects their solvency and liquidity, which is ultimately aimed at protecting their clients' interests. At the same time, resolving the issue of NPLs has a macro-prudential dimension as well, considering that the high rate of NPLs can pose a systemic risk. Systemic risk can occur if the aggregate lending activity is lower than it would be if the NPL ratio was not that high. The evidence shows that the level of NPLs is the indication of problems faced by a country's economy and its real sector, which is not capable to repay its debt, but it can also be a sign of a poor legal and judicial framework. Having this in mind, the resolution of NPLs requires a system-wide approach.

High level of NPLs became a burden during the crisis and ended up as a source of systemic risk not only in Republic of Serbia, but in many emerging economies. It is foreseen as one of constraints for lending activity and higher growth rates. The resolution of NPLs in Serbia has been slow to date. Proportion of NPLs that have been sold, written off or collected in last few years was not high enough. NPLs are weakening lending channel, and via lower credit supply, they are negatively affecting investment and economic recovery. There is also a feedback effect as sluggish recovery impacts the quality of bank credit portfolio, which becomes important determinant of banking sector performance. In the long-run, further build-up of NPLs can jeopardize financial system stability. NPLs are also one of the reasons behind more expensive lending activity, as banks often charge higher interest rates on new loans to cover losses stemming from the NPLs. Therefore, cleaning of the banking sector balance sheet became an imperative for supporting credit cycle at lower interest rates and helping the economy to return to higher growth rates.

Apart from the macroeconomic challenges that contributed to the NPL rise, there are also some bank specific factors that should be resolved. Due to the build-up of NPLs, credit standards tightened after the crisis. Yet, conservative credit approach can prevent inflows of new NPLs, but it will not resolve the current NPL stock. Therefore, more could be done to create the right incentives for banks to accelerate NPL resolution. In this respect, banking sector should introduce, where not yet introduced, workout units to improve their operational capabilities to manage the NPLs. Early warning systems should be developed and implemented in each bank that has relatively large credit portfolio. In order to foster resolution of NPLs, collateral valuation should be improved, information on NPLs should be more transparent, while some regulatory obstacles should be removed. Dealing with those issues calls for a joint and coordinated efforts of public and private sector.

Given the complexity of NPLs, resolution of the NPLs requires well-coordinated activities and strong involvement of all relevant stakeholders in building and implementing comprehensive NPL strategy. Having in mind causes of the high level of NPLs and complexity of the problem, both public and private sector are aware that the problem of NPLs cannot be resolved solely by the banking sector and without the Government's assistance. It requires mutual efforts and activities and, having in mind causes of high NPLs, it should go hand in hand with the real economy recovery. Therefore, success of the NPL resolution process will also depend on the implementation of proper incentives for market-based out-of-court debt restructuring, in combination with structural reforms. To make their business models sustainable, restructuring of the over-indebted companies needs to be followed with recovery of the economic activity over the medium term. Activities regarding debt enforcement and restructuring should include, in particular, strengthening safeguards to secured creditors' rights in insolvency proceedings. There are also issues regarding improvement of corporate governance that should go in parallel with the NPL resolution. Improving governance and imposing cost saving measures in companies under state control is a priority of the Government of the Republic of Serbia and of the structural reform process that has already started. While some improvements can be expected in the near-term, effective implementation will require perseverance and robust oversight.

Given all impediments for the NPL resolution in the long run, this Strategy is defined and will be implemented by collaboration and coordination of different governmental authorities - Ministry of Finance, Ministry of Economy, Ministry of Justice, Ministry of Construction, Transport and Infrastructure and Deposit Insurance Agency, on one hand, and the NBS, on the other hand, to be further supported by the expert assistance of the IFIs. As the problem was generated throughout the years, especially during the crisis, authorities in many countries decided to define strategy for NPL resolution with participation of all relevant institutions. Being a threat to financial system and representing a hindrance for investments and sustainable economic recovery, the resolution of the NPLs should be a joint work of all relevant stakeholders. IFIs are also helping in the process because

of their expertise in this field and “insights” from many countries. Given the complexity of the problem, an effective resolution may be achieved only by linking ongoing and future projects related to the NPL issue together, all to be part of a well-coordinated process. To this end, coordinated activities and measures of all relevant stakeholders, as well as coordinated implementation and organized monitoring of activities implementation are needed in order to achieve a positive outcome.

II GOAL AND KEY PRIORITIES

2.1. General Goal of the Strategy

This strategy aims to provide incentives and to eliminate barriers identified in the system preventing timely resolution of NPLs and to establish a system which will prevent the accumulation of non-performing loans to the level which might have a material adverse effect on credit activity jeopardizing potential economic growth. It is expected that undertaking measures prescribed by this Strategy should put NPLs level firmly on downward path. In achieving this goal, market-based solutions will be encouraged.

2.2. Key Priorities

In order to achieve the general goal, several key areas were identified which require improvement in (1) regulatory framework; (2) capacity building; and/or (3) implementation of laws:

- structural reforms, in particular resolution of SOEs slated for privatization/bankruptcy;
- enhancing banks’ capacity to deal with NPLs;
- enable conditions for NPL market development;
- improving and promoting out-of-court debt restructuring;
- improving in-court debt resolution and mortgage framework.

2.3. Enhancing banks’ capacity to deal with NPLs

In accordance with NBS regulations on risk management, banks are obliged to assess credit risk of the borrower, taking into consideration its specific characteristics, as well as to enable clear classification of lending into respective risk categories according to the degree of collectability and ensure continuous monitoring and verification of adequacy of ranking into these categories. This assessment also should be taken into account when determining the amount of value adjustment of balance-sheet assets and provisions for losses on off-balance sheet items.

Furthermore, banks are required to establish efficient monitoring of lending, including the system of early warning for increased credit risk, which enables timely identification of debtors with whom this increase occurred and which includes the definition of qualitative and quantitative indicators for early observance of increased credit risk.

NBS will in the period to come, along with activities related to EU integration and Basel III implementation Strategy and taking into account introduction of improved accounting standards (IFRS 9), analyze net effects of domestic specificities arising from classification rules, continuously safeguarding stability of the financial system. When crises hit Serbian market, NBS focused on introducing the counter-cyclical regulatory measures, whose effective implementation was possible due to significant amounts of capital positions and accumulated reserves formed in the pre-crises period. Particularly these reserves, on the one hand, absorbed losses caused by the crises and still represent key guarantor of the banking sector resilience to any potential shocks, while on the other hand, to a certain

extent, caused restraint of banks and the lack of their proactive approach in resolving non-performing loans.

The Decision on Bank capital adequacy (“Official Gazette of the RoS”, Nos. 46/11, 6/13 and 51/14) and the Decision on the Classification of Bank balance sheet assets and off-balance sheet items (“Official Gazette of the RoS”, Nos. 94/11, 57/12, 123/12, 43/13, 113/13, 135/14, 25/15 and 38/15) require banks to review the market value of real estate collateral at least every three years or more often, if the real estate market conditions changed significantly or the physical condition of the property changed. However, due to a lack of legally binding standards for valuation and separate specialized profession of appraisers, the NBS regulations recognize any court expert witness of relevant profession as authorized appraisers for these purposes.

Collateral valuation in general has proved to be an insufficiently regulated area. Such a situation has resulted in many instances in collateral overvaluation and significant differences in pricing of collaterals in mortgage enforcement procedures. In particular, largest problems exist in valuation of real estate and it appears that there is a need to improve regulation of (real-estate) appraisers, with the overall aim to strengthen the expertise, experience, credibility and integrity of the profession. Apart from the virtually non-existing legal framework for licensing or clear determination on the professional background of real estate appraisers, significant obstacles lay in the lack of commonly accepted methods of appraisal and lack of judicial expertise in deciding whether to accept the resulting valuations (in both enforcement and bankruptcy cases). For this reason, it is important to set clear and transparent valuation criteria and standards, in line with international good practices.

Additionally, already mentioned special diagnostic studies will be conducted on representative sample of banking sector assets (14 banks). Intention is to evaluate quality of receivables stated in banks’ balance sheets in accordance with IFRS and international collateral evaluation practices. These diagnostics will also provide to NBS the basics for identification of problems regarding collection and write-off practices. The focus of diagnostic studies will be on banks policies and procedures related to credit risk - the capacity of banks to manage non-performing loans, the definition of non-performing and restructured loans (NBS, EBA), impairment policies and processes and the quality of collateral valuation. Results of these studies will provide solid ground for further enhancement of banks supervision and regulation.

Bearing in mind that NPLs are inherent in the banking business, as well as the fact that NPLs occur more or less in the balance-sheets of banks depending on the phase of the economic cycle, it is necessary to straighten the capacity of banks to resolve NPLs on time and in optimal manner.

2.4. Enable conditions for NPL market development

Creating a market for selling and restructuring NPLs would allow for faster and more efficient resolution of distressed assets and complements restructuring efforts by banks. A distressed debt market would help banks to manage their NPLs, improve overall risk management, and promote corporate restructuring and would have broader macro benefits by reducing the corporate debt overhang. This in turn would complement financial restructuring by improving overall bank profitability.

However, at this moment, Serbian market for NPL is under-developed. While some banks have utilized affiliated special-purpose entities to help cleanse their balance sheets, transactions with third-party investors are practically absent.

Both supply and demand factors are behind the slow pace of NPL market development. Factors limiting supply relate to the limited incentives for banks to write off and sell NPLs, the

accounting treatment of the write-offs under IFRS, and a tax regime. The obstacles seem to be more on the financial than regulatory side. However, there are market, tax and other regulatory impediments to debt restructuring that have to be removed to enable restructuring and enhance the incentive for banks to sell.

Serbian banks remain heavily reliant on collateral. While collateral provides added security against losses, it encourages banks to adopt wait and see strategy and collect at the end of foreclosure rather than to dispose immediately and sell at high discounts. There is a significant bid-ask spread, which is, in part, linked to inconsistent and overly optimistic valuations of real estate collateral.

A small investor base and lack of equity capital have limited demand for distressed loans. Banks face inherent difficulties in corporate restructuring, given their traditional lending focus. Compared to banks, private equity or restructuring funds are better equipped in terms of risk capital and expertise to undertake debt and operational restructuring of distressed firms. The private equity market is almost non-existent. Institutional investors, such as pension funds and insurance companies, besides being very small in terms of market share, follow a fairly conservative portfolio strategy and do not invest in distressed debt.

Banks are precluded from selling retail receivables to third-party entities (not being banks). More specifically, the NPL market in the Republic of Serbia is at this point limited to transactions of distressed corporate loans, having in mind that Financial Services Consumer Protection Law forbids selling of retail loans to any legal entity other than bank. In the previous period NBS made significant progress regarding financial services consumer protection and every level of liberalization of retail NPLs transactions should be carefully analyzed. Namely, there are numerous issues which should be taken into account and number of preconditions to be fulfilled (lack of instruments of protection for natural person, licensing and supervision of potential buyer, etc.) before enabling liberalization of retail distressed loans in order to prevent possible negative effects on individuals and on the financial system as well. Along with aforementioned, personal data protection issues should be taken into account with particular attention.

2.4.1. Removing tax impediments

Tax treatment of NPL write-off or sale may represent a significant impediment for the development of the NPL market. Write-offs of uncollectable debt is not subject to taxation of banks, in terms of the corporate incomes tax, but under three cumulative conditions, one of which is the need to demonstrate that legal proceedings, either enforcement or insolvency, have been initiated. In practice, the magnitude of this disincentive is such that even in cases of NPLs that were fully provided for but where legal proceedings last for many years without any prospects for termination, banks do not opt for write off. On the other side, corporate debtors are subject to corporate income tax on the amounts of forgiven debts, but are allowed to offset such income against losses carried forward from the previous five years, which is in line with international best practices.

Banks are subject to tax burden in the context of restructuring of household debt. Currently, certain concessions (notably, forgiveness of principal and interest) granted to natural persons in financial difficulties are treated as income for personal income tax purposes. Banks are obliged to pay, by means of withholding, a personal income tax at a nominal rate of 20 percent (effective rate of 16 percent) on behalf of the individual borrower for the discounted loan portion. Exceptionally, personal income tax is not paid when the bank can demonstrate that the costs for initiating court proceedings against such borrower exceed the total amount of outstanding receivables due, but such evidence may be difficult to provide in practice. The resulting system—in which banks granting concessions to natural persons in financial difficulties incur an immediate tax liability, in addition to future cash flows that they are giving up—

generates strong disincentives for the restructuring of loans provided to natural persons. In order to eliminate this strong disincentive and providing it does not create a tax evasion vehicle, in cases when the bank provides concessions to a natural person in financial difficulties, the tax obligor for income tax purposes is the natural person, rather than the bank via withholding.

All tax incentives for debt restructuring need to be balanced with fiscal considerations. Some changes may be only temporary and act as a post-crisis measure that only remains in place until the clean-up of distressed debt has progressed. Annual fiscal costs of the proposed incentives should be carefully analyzed and documented.

2.4.2. Removing legal impediments

Legal uncertainties and a lengthy foreclosure process limit the options for and drive up the cost of restructuring. Despite improvements in the Law on Bankruptcy (“Official Gazette of the RoS”, Nos. 104/09, 99/11-other law, 71/12-constituional court and 83/14), the large backlog of cases continues to rise and there is a lack of uniform approach to the law by commercial courts across the country. Since 2005, various changes of the regulatory framework have allowed for both hybrid alternatives (prepacks) and out-of-court restructuring. Since 2010, when the authorities introduced a prepackaged restructuring procedure (PPRP) a growing number of large distressed debtors (more than 250 prepackaged plans with more than 2.5 billion euros of liabilities) have opt to file a prepackaged plan. Despite these improvements, most of these restructurings are not substantial with high ratio of debtors that end up in bankruptcy.

A specific problem for the sale of a disputed NPL may occur if the bank as the seller initiated litigation proceedings. This is due to the fact that current Civil Procedure Law (“Official Gazette of the RoS”, Nos. 72/11, 49/13-constitutional court, 74/13-constitutional court and 55/14) prevents the new holder of NPL to join (or take over) the existing litigation against the debtor, where the Appellate Commercial Court has taken the position that in such case the existing litigation is to be finished and, if the NPL is sold, the bank will eventually lose. This may have practical consequences in terms of the need to start the new litigation by the new holder of NPL, which may reduce buyers’ interest (and in cases where the statute of limitations has lapsed in the meantime, such a situation may have detrimental legal consequences).

2.4.3. Strengthening of the capacity of DIA for more efficient resolution of DIA’s state-owned and bankruptcy portfolio

The DIA resources and expertise are stretched considering its broad mandate. In addition to the DIA’s main responsibility as the institution responsible for deposit insurance and reimbursement of insured depositors, the DIA also acts as the bankruptcy administrator or liquidator of failed banks, insurance and leasing companies, and the institution in charge of management and recovery of assets assumed, under previous regulatory framework, on behalf of the RoS Government. Since 2011, the DIA has served as the administrator of the Investor Protection Fund. The processes of sale of the socially-owned capital in insurance companies are within the scope of the DIA, as well as the sale of the state-owned shares in local banks, but in case of the sales processes initiated before 1 April 2015.

To address these issues the DIA intends to: 1) develop a strategic plan for assets recovery as well as an annual operational plan to monitor performance of the management and employees in this area, 2) establish internal procedures and the required capacity to regularly perform asset valuations and assess the recoverable value of the associated collateral and its legal status, 3) strengthen capacity for resolution of its state-owned and bankruptcy NPL portfolios.

2.4.4. Assess other obstacles to the sale of NPL

It appears feasible to work further in order to assess other obstacles to the sale of NPL (whether legal, regulatory, accounting, data including in various public registries, or fiscal) to ensure that reform is comprehensive. To such end, the Ministry of Finance will engage outside consultants, in order to prepare jointly with banks, investors, experts and IFIs, a detailed assessment of all aspects related to the establishment and operations of asset management companies or other special purpose vehicles used for such purposes. The Working Group will diligently explore the need, tax and capital-flows implications as well as necessary safeguards for the potential liberalization of NPL sale to investors and entities established outside of Serbia. The results of such assessments should serve the Working Group as guidance for further legal and other measures and actions and for proposing necessary revisions of this Strategy to the Government and/or NBS, as applicable. Nonetheless, in proposing solutions for data impediments, the Working Group will have to observe existing legal framework in the area of data confidentiality, which sets the objective perimeter for potential interventions of the Working Group.

2.5. Improving and promoting out-of-court debt restructuring

Facilitating and incentivizing out-of-court restructuring could foster speedy and orderly corporate workouts. While Serbia is one of a limited number of countries that offer a full scale of voluntary, hybrid and formal (court) supervised restructuring options for their businesses and banks, the success of the consensual (voluntary) financial restructuring (CFR) mechanism as a restructuring tool has been rather limited. Within the first four years since the Law on Consensual Financial Restructuring (“Official Gazette of the RoS”, No. 36/11) came into full effect, only 37 cases were initiated and only 11 were successfully concluded. Out of the eleven successful cases, eight cases were concluded with a CFR restructuring agreement (in the form of an overriding creditors’ agreement) and in the remaining three cases, separate bilateral agreements were reached.

In practice CFR is triggered too late – when the debtor’s financial condition is irredeemably impaired and formal court-driven proceedings are more appropriate. One of the reasons for the low number of CFR cases appears to be insufficient awareness of procedural details and understanding of the advantages of the CFR procedure among debtors (less reputational damages) and, to some extent, banks. Besides simplification of the current legislative framework through changing the nature of standstill provisions and inclusion of sole proprietors (entrepreneurs) in the definition of eligible debtors, the CFR process would benefit from standardizing some of the agreements used in the process, improving the skill-set and specialization of mediators handling CFR cases and further increasing awareness about the CFR option to restructuring. Use of CFR and other alternative out-of-court restructuring arrangements would also benefit from further fiscal and regulatory incentives. Such incentives should be carefully balanced with fiscal considerations and could be a temporary, post-crisis measure.

While the proposals for expanding the scope and flexibility of the procedure represent a positive development, achieving greater efficiency of the CFR would require time and continued efforts in development of a negotiation culture in Serbian society in parallel with improving the institutional and judicial systems. In this regard, the recent adoption by the Serbian Banking Association of the INSOL rules for multi-creditor workouts may be helpful in guiding the participating banks moving toward the CFR.

2.6. Improving in-court debt resolution and mortgage framework

Serbian enforcement framework is burdened with excessive case workload and low court efficiency in handling such cases. Numerous reforms of court system added additional layer of delays and problems. Although the network of commercial courts operates at a better degree of efficiency, problems in the functioning of basic courts network are relevant for mortgage enforcement, as they have jurisdiction to handle such cases. Among the key factors contributing to the inefficiencies and the very low recovery rate of judicial foreclosures are delays due to court-overloads, inadequate in-court asset appraisals, ineffective judicial auctions, and failure to attract a sufficient interest to in-court auction sales. At the same time, market constraints continue to play a role.

On the other hand, the auction rules for the sale of debtor's property within the enforcement procedure are somewhat rigid and dis-incentivizing. This relates also to in-court procedure of mortgage activation and for this reason many market participants (banks in general) refrain from using this enforcement method. Albeit creditor-friendly at a glance, the two-auction rule with minimum starting price often proves not to be in the best interest of the mortgage creditor, in particular where it has reasonable expectations (or even a buyer) for the sale at (or around) 100% of the appraised market value (or in all cases where there is a limited number of buyers - one or two). This is true in particular in relation to the rule that a first auction of debtor's property starts at 60% of the estimated value of the property. On the other hand, this proves to be detrimental to the interest of the debtor himself. In any case, it is acknowledged that there has to be an efficient method of sale allowing for the completion of the procedure after two (or not more than three) attempts.

2.6.1 Improving bankruptcy framework

Bankruptcy framework has in the recent years included new restructuring options in the shape of the so called pre-packaged reorganization (*unapred pripremljeni plan reorganizacije* or UPPR). This was a welcome addition to the already existing bankruptcy reorganization. Both are governed by similar substantive rules, albeit with significantly different procedure (UPPR effectively takes place outside of formal bankruptcy, even if it uses several bankruptcy tools). Even though the law itself provides for a full range of restructuring and insolvency tools, practice has shown that these processes tend to be time-consuming in certain cases, whereby such time consumption is often misused and enabled by insufficiently clear process rules.

Meaningful debt restructuring in Serbia (in general and under the insolvency regime) is rare. UPPR rehabilitations (pre-packs) are used rather frequently, but in most cases only as techniques to restructure and extend loan repayments, with certain asset divestment in certain high-profile cases. An overall turnaround of the problematic debtors is rarely achieved. This could be attributed to various factors, including lack of strong enforcement and bankruptcy liquidation tools, lack of creditors' willingness to embark on a serious debt restructuring and significant difficulties of debtors to obtain fresh financing. As most financing in Serbia is secured, the existing shortcomings in protection of the secured creditors' rights contribute significantly to the challenges in obtaining new financing for debtors in financial trouble, but also the fact that no specific rules are in place for the protection and some additional comfort to the providers of new financing. It is also true that specialized funds in this area are lacking in the Serbian market for the time being.

The bankruptcy procedure itself is considered, by market participants, to be lengthy and inefficient, resulting in lower returns to creditors over prolonged periods of time. This is only partially due to the existing legal framework (which was acknowledged to be generally in line with best international practices) and even more so to the inefficient (and sometimes improper) implementation of

the existing laws and regulations. Secured creditors are in particular faced with significant challenges: their priority rights are often distorted or they are faced with significant delays in liquidation of secured assets. A formal objection to the decision of the bankruptcy administrator – as the only action available to them under the current framework - did not prove to be an efficient legal remedy and is often rejected. At the same time, secured assets are frequently leased out in order to fund bankruptcy proceedings for a prolonged period of time at the indirect expense and to the detriment of a secured creditor, who has no say in those activities.

As a general rule, the secured creditor should not be put in a worse-off position resulting in a materially lower recovery than within a normal enforcement framework. To this end, a more stringent rules on the maintenance of moratorium (i.e. lifting the stay) under bankruptcy could be helpful. It is held such a change in the law would help to focus the activities of the bankruptcy administrator on the liquidation of assets. This could create a more balanced approach between the interests of the debtor estate and its secured creditors. Such a change should be made in line with best practices, all in order to maximize the value of recovery. Practice shows that in many instances certain secured assets are not strictly necessary for reorganization, so in such cases it could be considered to allow for the secured creditor to request (and obtain) the lifting of the stay. The practice implies that if secured creditors had more powers over the asset appraisal, and subsequent sale/disposal, recovery rates on the secured assets would probably improve. Additionally, in many instances related to the reorganization plans there are significant disparities between the opinion of the debtor and the secured creditor on the determination of whether or not the secured creditor is over or under-secured. Such a determination is made by the bankruptcy judge, but due to its importance for the prospects of the secured creditor (in terms of both the voting process and the settlement rules) and its impact on the structure of creditors' classes under the reorganization plan, it may be warranted providing a right to an appeal for a dissatisfied party.

There is currently a complete lack of any rules regulating and/or coordinating the potential insolvency or reorganization of two or more related distressed companies. The largest portion of NPL concentration in Serbia is attributed to large companies and groups of companies. However, the insolvency framework provides for no regulation/coordination mechanisms for insolvencies of related or group companies. It is held that such cases require a higher degree of coordination and cooperation between the different bankruptcy administrators and a coordinated reorganization attempts, in particular where mutual relations are heavily interconnected by payment guarantees and production processes.

Bankruptcy procedure has become a complex exercise and highly-specialized court proceeding, requiring special skills and experience on the side of the bankruptcy judges. However, the Serbian legal system (and commercial courts in particular) have not fully responded to this change and there are no uniform rules on the selection and training of bankruptcy judges, who should be specialized judges with no other business in commercial courts. It is also noted that in certain commercial courts only one judge is assigned to bankruptcy cases, leading to a potential excessive caseload. This also warrants consideration of potential set up of a specialized bankruptcy court. There should be a uniform rule as to the maximum number of pending bankruptcy cases for each such judge (and this number cannot be the same as the one for normal litigation cases, but significantly lower) in order to allow the judge to invest time and efforts in examining the specifics of each case (and in particular the proposed reorganization plans and objections thereto filed by the creditors) and all inputs from numerous participants to this multi-party procedure, as it as a rule involve assets of significant value and competing interests from different stakeholders (as opposed to normal commercial litigation). It should also allow the judge to properly and more strictly supervise the work of the bankruptcy administrator in all relevant details (e.g. in exercising its authority to examine and approve more carefully - contrary to the overwhelming practice - monthly listings of costs of the bankruptcy procedure, and in ensuring full compliance with all relevant laws and regulations).

In particular, bankruptcy judges usually lack economic and financial knowledge and skills, resulting in their overwhelming reliance on the inputs provided by the bankruptcy administrators. There is still a common view among the judges that the bankruptcy administrator is a body of the court (or its assistant), as it used to be in the past, as opposed to its current role as the organ of the proceedings, together with the creditors bodies. This somewhat improper perception prevents many judges from accurately applying statutory provisions and discretionary powers vested in them by the statute, especially in dispute-like situations between the debtor and its creditors, but also between the creditors themselves, or in disputes between the secured creditor and the bankruptcy administrator.

All this should enable the creation of conditions for swifter and more efficient bankruptcy procedure, resulting in higher and quicker returns to creditors. In cases where reorganization is warranted and approved, it should result in the quick exit of the restructured debtor from the formal court proceedings, allowing it to continue its normal business life.

2.6.2. Improving mortgage establishment and enforcement

The existing mortgage framework dates back to 2005 and after 10 years of practice its inconsistencies and ambiguities are exposed to a large extent, resulting in many practical problems for mortgage enforcement. In mortgage establishment, one of the main problems lies with the inefficient functioning of the Real Estate Cadaster in some of the key business areas such as Belgrade, Novi Sad, Nis and Kragujevac. It effectively prevents the inscription (registration) of a mortgage due to previous unresolved changes involving the same land parcel or other real estate. In some instances, it may take more than a year to achieve mortgage registration. This generates legal uncertainty and unnecessary risks for the mortgage creditors.

Mortgage activation is also faced with significant problems in practice. This is true for both out-of-court mortgage activation as well as for the court enforcement procedure. One part of the problem lies with the unclear language of the statute, but the other part is related to the inefficient functioning of the system as a whole.

Out-of-court mortgage activation is faced with three main obstacles in reality. First, there are problems in timely registering the annotation of mortgage activation in certain land registries with high backlog of cases. Second, as debtors have a right to appeal such annotation, there is a need for a second instance decision-making, which is rarely resolved in a timely fashion (usual timeframe for deciding upon appeal is more than two years). This in reality renders the entire process unacceptably slow. And third, in cases where debtors succeed in registering a lower rank mortgage prior to mortgage sale, the current interpretation of the language of the existing statute by the courts makes it impossible to delete any such lower ranked mortgages following a mortgage sale. Finally, with any change in rules coming in place allowing for a more efficient out-of-court mortgage activation, the fairness of the process for all stakeholders (owner, first rank mortgage holder and possible lower ranked mortgage holders) would largely depend on proper and precise framework for property appraisals.

The court enforcement procedure for mortgage activation and sale of secured asset is burdened with inefficiency of basic courts with jurisdiction for such procedures. In effect, due to a high backlog of enforcement cases in basic courts, judges are faced with an extremely high workload and have to deal with myriad of low-value enforcement cases, not allowing them to focus sufficient efforts and attention on high-value cases and mortgage sales. In case of more complex collaterals (such as industry real estate and yielding assets such as gas stations, etc.) judges of basic courts lack sufficient expertise in determining the value of such collateral (even on the basis of an expert opinion), which is an important step of the procedure, decisive for the entire sale process. As already indicated above,

enforcement procedure would also benefit from the introduction of mechanisms of proper and fair property appraisals.

2.6.3. Assessing the need, feasibility, and timing of introducing a personal insolvency framework

The need, feasibility, and timing of introducing a personal insolvency framework in Serbia should be carefully analyzed. The outstanding stock of household NPLs in Serbia is relatively contained, representing about 10 percent of total household loans, and 16 percent of total NPLs. While the personal insolvency framework is an important tool for addressing over-indebtedness in the household sector (at 33 percent of total banking loans in Serbia), there is no immediate term priority for the introduction of such framework. Furthermore, it may take time to meet the necessary preconditions for establishing an effective personal insolvency regime.

To assess the need, feasibility and timing of introducing a personal insolvency framework, the Working Group, backed by the participating institutions, will conduct a study in order to identify all formal debt reduction solutions which allow consumers to return to a financially sustainable path. The study should provide details on the nature of the solution, the condition the debtor needs to find themselves in to access the solution, the legal, financial and other consequences of having used a particular debt solution, and the effectiveness of such solutions in practice and identifies best practice.

III ACTIVITIES – POLICIES AND MEASURES

In order to achieve the general goal of the strategy and with a view to its key priorities, competent bodies and institutions shall carry out number of planned and coordinated activities. The Action Plan for the implementation of the Strategy contains details of all such activities, with the identification of the institution in charge, envisaged deadline and the expected output for each individual activity.

3.1. Activities on enhancing banks' capacity for dealing with NPLs

NBS will undertake activities within its competence aimed at straighten the capacity of banks to resolve NPLs, in accordance with its legal powers and in line with Memorandum of Economic and Financial Policies signed by the representatives of the Republic of Serbia and the Governor of the NBS.

The National bank of Serbia will:

- conduct SDS and following completion of SDS analyze modalities for fine tuning of the respective regulatory framework for banks;
- undertake supervisory and regulatory activities with the aim of strengthening regulatory treatment of restructured receivables and aspects of distressed loan management in banks;
- undertake activities regarding enhancement of implementation of IAS 39 by banks;
- undertake activities with the aim of enhancing disclosure regarding asset quality of banks;
- develop a database, accessible to banks and appraisers, for detailed records on residential and commercial real estate collateral valuations filed according to pre-established criteria.

In order to support this activity by enabling regulating collateral valuation, the Ministry of Finance will:

- improve regulation of real estate appraisers, with the aim to strengthen the expertise, experience, credibility and integrity of the profession;
- improve accuracy of real estate valuation, in line with international good practices, by way of establishing transparent valuation criteria and standards, in line with international good practices.

3.2. Activities to enable conditions for NPL market development

Given the variety of conditions that need to be enabled for development of this market, especially in the area of tax, legal, capacity, data and other obstacles, a multipronged approach is necessary.

The Ministry of Finance will:

- consider allowing for recognition of banks' corporate loan write offs as expenditure for tax purposes without the need to start legal proceedings for loans past due for more than two years, by amendments to Corporate Income Tax Law („Official Gazette of the RoS”, No. 25/01, 80/02, 80/02-other law, 43/03, 84/04, 18/10, 101/11, 119/12, 47/13, 108/13, 68/14-other law and 142/14);
- consider abolishing the requirement for banks to pay on withholding basis the personal income tax for debt forgiveness to private individuals, by amendments to Personal Income Tax Law („Official Gazette of the RoS”, No. 24/01, 80/02, 80/02-other law, 135/04, 62/06, 65/06-correction, 31/09, 44/09, 18/10, 50/11, 91/11-CC, 7/12, 93/12, 114/12-CC, 8/13, 47/13, 48/13-correction, 108/13, 6/14, 57/14, 68/14-other law and 5/15);
- in case of parliamentary approval of the aforementioned tax incentives, immediately issue univocal interpretive guidance on the implication of new tax legislation in the context of NPL resolution to help reduce uncertainty for borrowers and creditors and ensure evenhandedness;
- conduct a comprehensive review of tax legislation with the aim to identify other (potential) obstacles, including tax implications that may materialize in the context of NPL sales, and prepare (if needed and having in mind fiscal sustainability) other amendments of tax legislation and/or binding instructions for Tax Administration staff.

One of the specific legal obstacles that seriously impedes market development will be addressed by the Ministry of Justice that will:

- consider ways to resolve the existing problem of sale of NPLs in the course of litigation procedure (e.g. by allowing for the change of plaintiff due to NPL sale in the course of the litigation proceedings without the need for the consent of the defendant or, alternatively, by clarifying the existing rules on the finalization of pending litigation in order to remove uncertainty on the use of such final decision by the new NPL holder).

Given that DIA manages a substantial portfolio of state-owned NPLs, it can have a substantial impact on the NPL resolution process as well as on the NPL market development. In order to do so, it will in cooperation with the Ministry of Finance:

- develop and adopt a Strategic Plan for Asset Management (to be operationalized in an Annual Operational Plan) to include: (i) multi-year cash-flows from recovered proceeds of bad assets that have been restructured, bad assets linked to privatization and other forms of recovery; (ii) expenses related to the management of the bad assets portfolio and (iii) defined measures for monitoring performance of the management and employees in this area;
- establish internal procedures and the required capacity to regularly perform asset valuations and assess the recoverable value of the associated collateral and its legal status;
- improve the capacity of staff to contribute the solving of the problems of NPLs, due to the fact that make a significant share of the total observed NPLs, which can lead to the strengthening of stock of NPLs that can potentially be offered to the market. Therefore, the creation of a consolidated NPL team (to be properly staffed and train) will create conditions for strengthening the capacity to deal with its NPL portfolios in state-owned as well as in the bankruptcy proceedings.

Even though the issue of retail NPLs is non-trivial, it is to some extent more complex and sensitive relative to the corporate NPL segment. To that end, the National Bank of Serbia will:

- conduct comprehensive analysis with the aim to determine potential effects of possible liberalization of assignment of retail NPLs and to identify legal and other obstacles regarding this issue.

The Ministry of Finance will explore and pay attention to the following impediments:

- data impediments, other than the abovementioned collateral database or bank disclosure issues and to the extent that they are not treated by the relevant legal framework in the area of data confidentiality, that are reported important to potential investors, will be explored jointly in consultations with banks, investors, experts and IFIs;
- other impediments (whether legal, regulatory, accounting or fiscal) that are related to the establishment and operations of asset management companies or other special purpose vehicles used for such purposes will be explored and addressed in close cooperation with relevant stakeholders. A detailed assessment will include all aspects of this issue, including the need, tax and capital-flows implications as well as necessary safeguards for the potential liberalization of NPL sale to investors and entities established outside of Serbia.

3.3. Activities on improving and promoting out-of-court debt restructuring

Given that the framework is already in place but it needs improvement and promotion, the Ministry of Economy will:

- in cooperation with the Serbian Chamber of Commerce: streamline and simplify the existing CFR procedure, allow for entrepreneurs to apply for the CFR procedure and improve the framework for mediators' participation (in terms of their selection and fee structure) enabling a larger interest from skilled mediators to apply to participate in CFR procedure, all by proposing amendments to the existing CFR Law and relevant by-laws;

- in cooperation with the Serbian Chamber of Commerce: work to further promote awareness of the out-of-court restructuring framework for market participants through workshops and seminars;
- in cooperation with the Serbian Chamber of Commerce and Association of Serbian Banks: strengthen support provided by the Serbian Chamber of Commerce to SMEs (and private entrepreneurs if they are allowed to participate in the out-of-court restructuring) in the preparation of viable restructuring plans and further negotiation with their financial creditors; develop a template of the key financial and business data to be provided by the debtor to its financial creditors at a starting point of the CFR proposal;
- support these efforts by formally instructing/proposing to state creditors (including in particular Development Fund and Export Credit and Insurance Agency) to act efficiently and constructively in the out-of-court financial restructuring (including in CFR procedure), with clear deadlines and framework terms publicly announced for all cases (or categories of cases).

The Ministry of Finance will support the out-of-court debt restructuring by:

- considering ways to support these efforts by instructing/proposing to the Tax Office to act efficiently and constructively in the out-of-court financial restructuring (including in CFR procedure), with clear deadlines and framework terms publicly announced for all cases (or categories of cases).

3.4. Activities on improving in-court debt resolution and mortgage framework

In line with its mandate, the Ministry of Economy (in cooperation with Bankruptcy Supervisory Agency) will undertake the following activities needed to improve this particular segment:

- enhance safeguards for secured creditors in both reorganizations and winding-up (*bankrot*) by (1) shortening the time period for making the decision on (a) winding-up (*bankrot*) and (b) possible sale of legal entity (i.e. sale of business as going concern), *inter alia* by providing strict rules on possible reorganization attempts and preventing prolonged reorganization proceedings; (2) providing for a swift disposal of all assets not strictly necessary for reorganization; (3) providing strong dis-incentives for failure to liquidate assets within 6 months following the decision on winding-up (*bankrot*), which may be extended for up to 60 days due to the implementation of previous actions for a public invitation for the sale provided for in the bankruptcy proceedings, in which case specific conditions for lifting of moratorium will be introduced; (4) allowing secured creditors to actively participate in creditors' decision making (i.e. by providing consent or in other appropriate manner to be able to protect their legitimate interest) on lease and sale of secured assets, as well as in preparatory activities for reorganization and decisions on (a) course of bankruptcy procedure (i.e. reorganization attempt or early decision on winding-up), (b) sale of legal entity and (c) sale of functional group of assets (*funkcionalna celina*), and (5) providing them with efficient tools and legal remedies in relation to secured assets valuation in the sales process (both on individual basis or as part of the legal entity or functional group of assets sales) as well as in terms of creditors' classes formation in reorganizations (both in bankruptcy and pre-pack), all by amending the Bankruptcy Law;

- consider the adoption of additional rules for bankruptcy proceedings for distressed group entities in order to provide for more time-efficient and procedure-efficient handling of multiple bankruptcy or reorganization cases for such entities (with peer countries review), by amending the Bankruptcy Law;
- consider strengthening protection of new financing in reorganization, but with safeguards for secured creditors and avoidance of abuses, by amending the Bankruptcy Law;
- strengthen capacities of BSA through technical advice and training program, increase number of supervisors, consider, if necessary, through amendments to the positive regulations the modalities to exclude risk of collusion by randomly selecting supervisors for case files review on a monthly basis;
- revise administrator's fees to incentivize timely sale of assets or business entity, related to the success in sales and/or settlement of creditors; consider limiting and/or introducing strict conditions for advance payments of administrator's fees;
- allow more leeway to creditors in selecting bankruptcy administrators in order to create incentives for a development of a professional services' industry.

The Ministry of Justice, in line with its mandate and reform agenda, will:

- in cooperation with the Judicial Academy, Appellate Commercial Court and Bankruptcy Supervisory Agency: enhance bankruptcy courts' handling of bankruptcy sales, prepackaged and bankruptcy reorganization plans and related procedures, by implementing a complex training (in particular in the economic and financial aspects of reorganization plans and bankruptcy sales) of bankruptcy judges and by setting up within the legal framework an efficient mechanism of tracking all bankruptcy and reorganization cases lasting more than 6 months where (a) a decision on the reorganization plan was not made in the first instance; and/or (b) a decision on winding-up (*bankrot*) was not made in the first instance, in all such cases introducing a special degree of Appellate Commercial Court scrutiny;
- in cooperation with the Ministry of Finance: consider efficient solution for the problem of competing procedures of out-of-court and in-court enforcement of mortgages (e.g. in terms of providing clear rules on precedence of one procedure over the other);
- consider adopting changes to the legal framework for efficient tracking of court cases in order to operationalize already existing rules of transparency for all bankruptcy case files contained in the Bankruptcy Law, all in order to secure full transparency of all filings, briefs, evidence and court and bankruptcy administrators' decisions and documents contained in the court's case file, in electronic versions, via court docket internet site to all parties participating to the bankruptcy proceedings;
- consider the type of auctioning in corporate and entrepreneur enforcements (including mortgages), especially first auction with starting price of 100% of estimated value upwards and second auction of a Dutch type with 100% starting price downwards, with determining (if any required) a minimal level of sale price and a debtor's right-of-first refusal at the second auction;

- consider providing for Commercial Courts' jurisdiction for all court enforcement cases against companies and entrepreneurs, with analyses on possible transfer (and impact) of existing case backlog.

The Ministry of Finance will propose amendment to the Mortgage Law that will:

- allow the buyer of a collateral property out-of-court to purchase it free of lower ranked liens, but provide sufficient protection of lower ranked mortgage creditors in terms of proper valuation to be used for such out-of-court sale.

The Ministry of Construction, Transport and Infrastructure (in cooperation with Republic Geodetic Institute) will:

- create a functional second-instance decision process for land registry case files;
- identify specific land registry branches (territories of Belgrade, Nis, Novi Sad and Kragujevac) with high backlog of case files and improve their efficiency;
- ensure uniform application of the rules on changes of elements of registered mortgages in case of restructured loans under out-of-court, CFR or pre-pack restructurings.

The Working Group will, with the support of the participating institutions, identify and instruct the relevant state institution to:

- conduct a study in order to assess the need, feasibility, potential problems that need to be addressed and timing of introducing a personal insolvency framework in the Republic of Serbia.

IV ACTION PLAN(S)

The Action plan for the implementation of the Strategy is laid out in the form of the matrix and attached to this Strategy as an integral part. It should be noted that due to the Constitutional and institutional independency of the NBS, the attached action plan will cover the activities of all government ministries and other state institutions, except for the NBS which shall adopt its own action plan (to be aligned with this Strategy and in particular with the list of NBS-related activities specified in Section III above). Each of the action plans will consist of detailed steps to be undertaken, with timeframe, expected output and the list of institutions in charge thereof.

V FOLLOW UP

This Strategy is envisaged to be a three-year continuous process. It is expected that the existing Working Group as set by the decision of the Government of Serbia 05 No. 02-5145/2015-1 dated May 11, 2015 will be at the helm thereof. It will be in charge of continuously supervising the implementation thereof, and identifying any residual risks and challenges to be addressed.

Working Group will be obligated to prepare bi-annual reports to the Government of Serbia and to the NBS by end of Q1 and Q3 of each year. Such report will be supported with (if required) the proposal for the amendments to the Strategy, depending on the reports and information received on the implementation of the action plans. To that end, each of the lead institutions in charge of specific activity under the Action Plan will have an obligation of quarterly reporting to the Working Group on the

implementation of the Action Plan and possible open issues to be discussed (and resolved, if need be) at the level of the Working Group. Working Group will also take into consideration any new inputs provided to the Working Group by other state institutions and other stakeholders (including international financial institutions) as well as market circumstances and further market development that may give rise to a need for reconsideration of previously adopted actions and measures and/or introduction of new ones and, consequently, for the revision of this Strategy to be discussed and proposed by the Working Group to the Government and/or NBS.

A close cooperation and information flow will be maintained with the NBS. NBS will inform the Working Group on a quarterly basis on the implementation of its own action plan, in order for the Working Group to have an accurate and all-inclusive view on the performance of the entire Strategy and to be able to inform the Government thereon.

Table 3: Key macro-prudential indicators

Republic of Serbia: Banking sector indicators

(in % unless otherwise indicated)

	2008.	2009.	2010.	2011.	2012.	2013.	2014.
Capital Adequacy							
Regulatory capital to risk weighted assets	21,9	21,4	19,9	19,1	19,9	20,9	20,0
Tier I capital to risk weighted assets ¹⁾	17,9	16,5	15,9	18,1	19,0	19,3	17,6
Capital to assets	23,6	20,7	19,7	20,2	20,5	20,9	20,7
Asset Composition and Quality							
Agriculture loans to total loans	3,3	3,1	3,0	2,8	3,0	2,7	3,5
Industry loans to total loans	18,4	17,9	19,3	17,2	17,9	18,4	19,2
Trade loans to total loans	16,9	17,3	16,6	14,7	15,0	13,5	13,9
Construction loans to total loans	5,8	5,3	6,9	6,2	5,8	4,6	4,2
Other loans to enterprises to total loans	8,1	9,8	9,7	10,9	12,8	11,4	11,5
Loans to households to total loans	36,3	32,9	34,1	32,4	33,6	35,4	38,2
Of which: Mortgage loans	13,9	13,8	15,4	15,0	16,1	16,8	18,0
Loans to other economic sectors to total loans	11,3	13,8	10,5	15,7	12,0	14,0	9,6
Gross non-performing loans (NPL) to total gross loans	11,3	15,7	16,9	19,0	18,6	21,4	21,5
Net non-performing loans (NPL) to total net loans	5,3	8,5	9,8	10,5	10,4	11,9	11,1
Specific provisions of total loans to total gross loans	8,3	9,6	9,1	10,9	10,2	11,9	12,7
IFRS provisions of total loans to gross non-performing loans (NPL)	73,2	61,4	53,9	57,0	54,9	55,8	59,0
Specific provisions of NPL to gross NPL	56,9	50,9	47,2	51,0	50,0	50,9	54,9
Regulatory provisions to gross non-performing loans (NPL)	153,6	142,5	133,6	121,4	120,7	113,8	114,5
Large exposures to regulatory capital	36,6	37,4	43,3	110,1	104,5	90,4	130,5
Earnings and Profitability							
ROA	2,1	1,0	1,1	0,1	0,4	-0,1	0,1
ROE	9,3	4,6	5,4	0,2	2,1	-0,4	0,6
Net interest margin to average balance sheet assets	5,7	5,1	4,6	4,6	4,3	4,2	4,3
Net interest margin to gross operating income	64,2	67,0	68,3	72,0	69,2	72,6	72,3
Operating expenses to gross operating income	59,0	62,6	63,5	61,8	66,1	65,3	64,7
Operating expenses to average balance sheet assets	-5,2	4,8	4,3	3,9	4,1	3,8	3,9
Personnel expenses to operating expenses	41,2	41,9	41,1	41,9	38,3	39,4	37,0
Liquidity							
Liquid assets to total assets	43,3	41,5	35,1	37,8	34,5	38,5	37,1
Liquid assets to short-term liabilities	68,6	63,6	56,4	62,8	57,5	62,2	58,6
Liquid assets (core) to total assets	31,1	28,7	23,8	27,5	26,8	29,0	29,0
Liquid assets (core) to short-term liabilities	49,3	43,9	38,1	45,6	44,8	46,9	45,8
FX-denominated and FX-indexed loans to total gross loans	68,8	70,2	71,0	69,0	73,1	70,9	70,0
FX-denominated and FX-indexed deposits to total deposits	71,8	75,4	79,1	75,7	77,6	73,3	72,1
Loans to non-financial sector to deposits of non-financial sector	125,3	124,8	125,9	127,0	119,9	113,8	102,5
Loans to non-financial and non-public sector to deposits of non-financial and non-public sector	127,1	125,3	122,8	124,1	117,8	112,5	102,4
FX denominated and FX-indexed loans to FX denominated and FX-indexed deposits	109,8	99,8	99,1	109,7	106,7	105,3	95,9
Deposits to total assets	57,7	60,2	59,4	57,9	59,0	60,7	63,7
FX denominated and FX-indexed liabilities to total liabilities	74,3	77,8	81,8	79,0	80,1	76,7	74,5
Sensitivity to Market Risk							
Net open FX position (overall) to regulatory capital	7,4	3,6	3,9	6,2	5,5	4,4	3,9
Classified off-balance sheet items to total assets	121,4	106,7	97,7	111,0	103,5	111,0	207,1
Classified off-balance sheet items to total classified balance sheet assets	56,2	43,3	33,9	32,0	26,1	28,8	27,6

¹⁾ An adjustment is made in the deductibles of Tier 1 capital.

Source: National Bank of Serbia.

Table 4: Financial sector structure

	2008			2009			2010			2011			2012			2013			2014		
	No.	RSD billion	%	No.	RSD billion	%	No.	RSD billion	%	No.	RSD billion	%	No.	RSD billion	%	No.	RSD billion	%	No.	RSD billion	%
Financial sector (in % of GDP)	85	1.989	100,0	88	2.378	100,0	84	2.759	100,0	87	2.868	100,0	85	3.108	100,0	80	3.081	100,0	78	3.227	100,0
		74,7			87,4			95,7			89,4			92,8			85,2			83,2	
Banking system	34	1.777	89,3	34	2.160	90,8	33	2.534	91,8	33	2.650	92,4	32	2.880	92,6	30	2.846	92,4	29	2.969	92,0
State-owned banks	8	284	14,3	9	378	15,9	8	454	16,4	8	472	16,5	8	522	16,8	6	534	17,3	6	571	17,7
Local private banks	6	154	7,7	5	178	7,5	4	217	7,9	4	213	7,4	3	194	6,3	3	196	6,4	2	187	5,8
Foreign-owned banks	20	1.339	67,3	20	1.605	67,5	21	1.863	67,5	21	1.965	68,5	21	2.163	69,6	21	2.117	68,7	21	2.211	68,5
Greek	4	301	15,1	4	353	14,8	4	427	15,5	4	393	13,7	4	426	13,7	4	409	13,3	4	418	12,9
Italian	3	352	17,7	3	457	19,2	2	526	19,1	2	591	20,6	2	657	21,1	2	679	22,0	2	738	22,9
French	2	107	5,4	2	140	5,9	3	202	7,3	3	263	9,2	3	287	9,2	3	299	9,7	3	304	9,4
Austrian	4	387	19,4	4	454	19,1	4	469	17,0	4	493	17,2	3	449	14,4	3	429	13,9	3	441	13,7
Other	7	193	9,7	7	202	8,5	8	238	8,6	8	225	7,8	9	345	11,1	9	301	9,8	9	310	9,6
Nonbank financial institutions	51	212	10,7	54	218	9,2	51	226	8,2	54	218	7,6	53	228	7,4	50	235	7,6	49	258	8,0
Insurance companies	24	85	4,3	26	99	4,2	26	117	4,2	28	126	4,4	28	140	4,5	28	148	4,8	27	169	5,2
Pension funds	10	5	0,2	11	7	0,3	8	10	0,4	9	12	0,4	9	16	0,5	6	20	0,6	6	24	0,7
Leasing companies	17	123	6,2	17	111	4,7	17	99	3,6	17	80	2,8	16	72	2,3	16	67	2,2	16	65	2,0

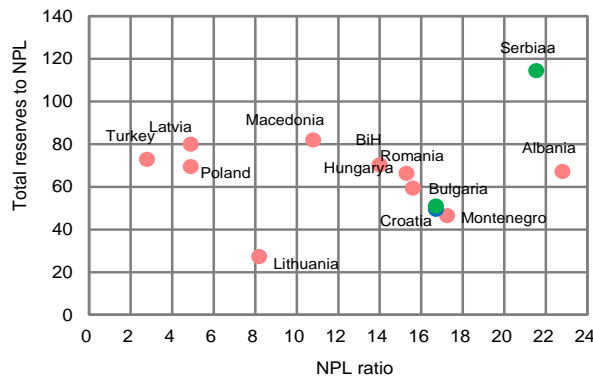
Source: National Bank of Serbia.

Cross-country experience

High and rising levels of NPLs became the source of systemic risk in many countries in the region. The upward trend of NPLs started with the outbreak of the financial crisis, especially year after, when macroeconomic conditions deteriorated (economic activity contracted, unemployment rate increased, while local currencies depreciated). As a result, the average NPL ratio of the region² is about 8 p.p. higher at the end-2014 compared to 2008.

At the reached levels, NPL became a constraint to credit supply. Impaired lending channel became a constraint for economic activity. With this in mind, many countries are at the moment considering to develop national strategies for NPL resolution. Some of them already established inter-institutional working groups to deal with the NPLs, while some will establish them in the near future.

Chart 12: Coverage of NPL by total reserves and NPL ratios
(2014, latest available data, %)



Sources: NBS and IMF: GFSR.

Chart 13: Developments of NPL ratio, region
(2014 relative to 2008, pp)

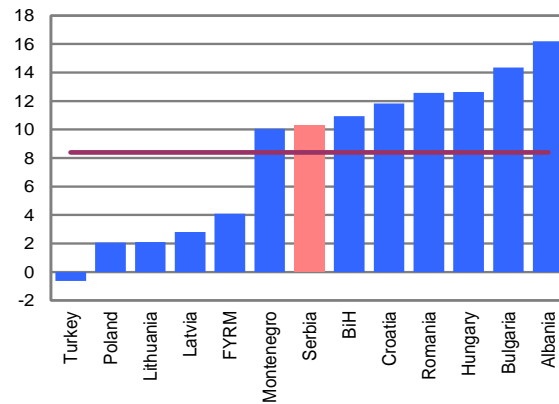
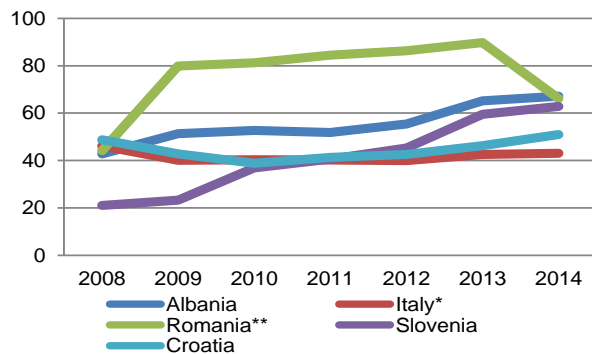


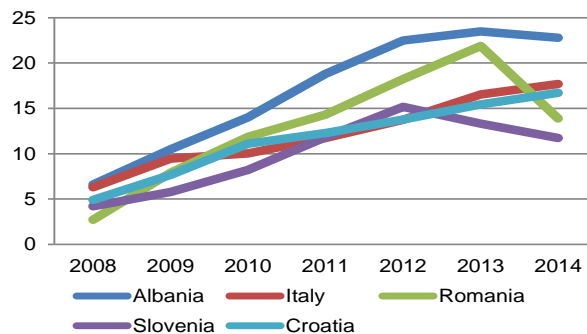
Chart 14: Coverage of NPLs by total reserves, region (%)



* June 2014.

** September 2014.

Chart 15: NPLs to total loans, region (%)



Source: GFSR, April 2015.

² Emerging and Developing Economies in Central and Eastern Europe: Albania, BiH, Bulgaria, Croatia, Hungary, Latvia, Lithuania, FYROM, Montenegro, Poland, Romania, Serbia and Turkey.

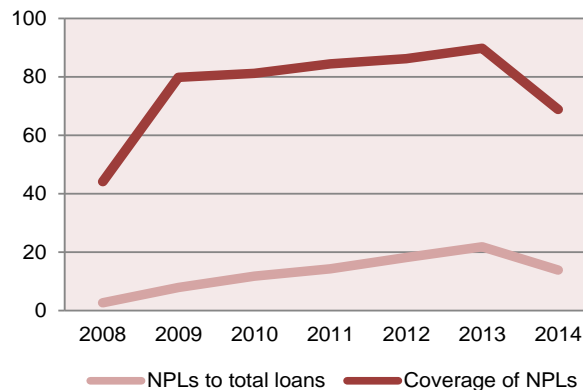
Romania

Rise in NPLs ratio in **Romania** was caused by downtrend in lending and modest economic growth pace. The NPL ratio picked to 21.9% at end of 2013. Share of household NPL was 13.7% while for corporates it reached 29.1% by the end of 2013. Macroeconomic factors have had a stronger influence on loan quality (real GDP growth rate in 2009 was -7.1%) compared to bank specific ones, while foreign exchange lending in Romania is source of systemic risk (share of lending euroisation is around 60%). The worst performers, measured by the NPLs ratio, were subsidiaries of the Greek banks (more than 30%) and the Ireland banks (around 25%), while the least coverage of NPLs refers to Italian subsidiaries. In the context of NPL portfolio restructuring, banks used debt cancellation techniques to a limited extent up to 2014. Credit risk stemming from NPLs is mitigated via comfortable provisioning and solvency ratios. Recognizing the NPLs as a source of systemic risk, in 2014 the National bank of Romania recommended the banks to write-off NPLs which are fully provisioned. Comprehensive central bank's NPLs resolution strategy is based on the following elements:

- fully provisioning exposures with more than 360 days in arrears, and removing them from the balance sheets,
- encouraging all banks to fully provision exposures to companies that entered insolvency status, and removing these exposures from the balance sheets and
- modifying NPL calculation to meet the EBA's definition.

The measures accelerated NPLs sales and write-offs and higher provisioning and helped NPLs to decline in 2014 by around 8 p.p. to 13.9%, with an IFRS provisioning ratio increased to 68.9%. At the same time, profitability indicators turned negative with ROA of -1.32% and ROE of -12.45% at end-2014.

Chart 16: Coverage of NPLs by total reserves and NPL ratio, Romania (in %)



* Coverage drop was due to change in methodology.

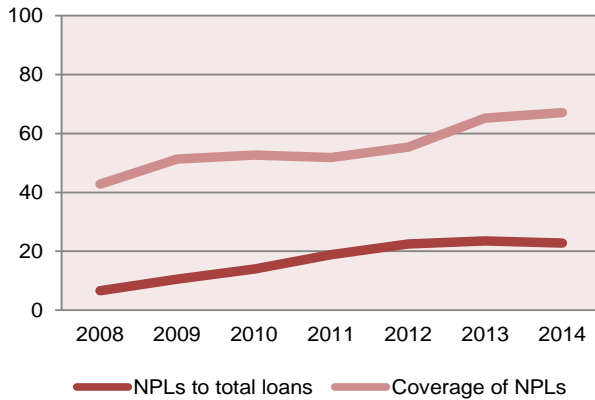
Albania

Albania has the highest NPL ratio in the region, with a progressive dynamics. NPLs are mostly concentrated in construction and manufacturing industry, the sectors that were strongly hit by the crisis. The lending activity saw significant increase in the period from 2003, causing domestic credit to GDP ratio rise from around 7% to around 40%. In parallel, level of loan euroisation also picked up to around 50%. Such growth was facilitated by the increase in credit demand in years of GDP growth and the constant increase in the level of banking intermediation. The economy grew by an average annual growth rate of 6 percent in the decade before the crisis, while after 2009 growth rates were much lower. Levels of NPL saw increase with the outbreak of financial crisis. The credit risk models on which the portfolios were developed did not foresee the severity and longevity of the economic crisis. Also, there is evidence of poor financial planning and reporting from banks clients that resulted in poor evaluation of business potential. As such, the level of NPL went from 3.3% at the end of 2007 to 22.8% at the end of 2014.

During 2014, banks were active in writing off loss loans - 12 of 16 banks of the sector wrote off and/or transfer loss portfolios from their balance sheets (NPL ratio decreased from 24.1% at the end of June 2014 to 22.8% at the end of 2014). In H2 2014, lending activity manifested recovery signs, supported by the improved economic activity, further decrease in financing costs and the payment of Government's arrears.

In order to address the issue of NPLs, inter-ministerial group was formed in 2015 consisting of representatives of the Bank of Albania, Ministry of Finance, Ministry of Economy and Ministry of Justice. The comprehensive strategy elements will be related to NPL write-off from balance sheets, as well as some regulatory issues.

Chart 17: Coverage of NPLs by total reserves and NPL ratio, Albania (in %)

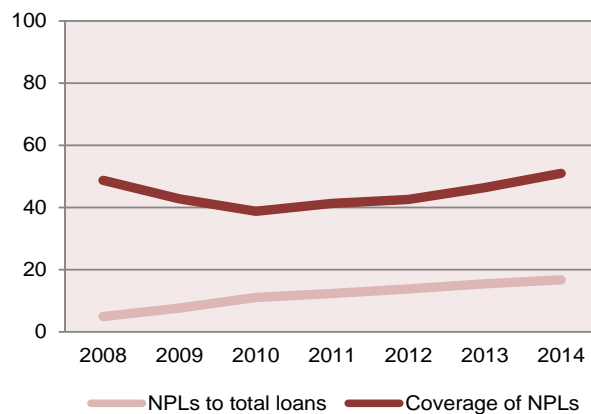


Croatia

The quality of aggregate loan portfolio in *Croatia* continues to deteriorate, partially due to the economic contraction, while partially due to classical ageing of the NPL portfolio. At the end of 2014 NPL ratio was at 16.7% (with much higher ratio in corporates, over 30%).

The coverage of NPLs rose to 51.0%, which is the result of developments in all the categories, but primarily those in the corporate sector. After the end of 2013, when the coverage rose as a result of amendments to the Decision on the classification of placements and banks' preparations for asset quality review (AQR), the coverage of NPLs continued to grow as a result of ageing of existing NPLs, which have become the most important determinant of the developments in bank earnings. The results of NPLs resolution policies have been moderate so far. Since the beginning of the crisis, the banks have cumulatively sold (mostly by one foreign bank and mostly to associated companies, but there is also evidence of selling NPLs to private financial intermediaries specialized in collecting claims), written-off or taken over collateral for some 33% of NPLs by the end of 2014. Had there been no such activities, the NPL ratio would have been at approximately 20%. Still, there is evidence of inertia of some banks when dealing with NPLs, where resolution of NPLs is accelerated only four to five years after they enter into NPL category. Judicial proceedings are slow, some activities were already taken (supervisory changes, pre-bankruptcy settlements), but they are expected to give results in the two to three year horizon. Law success rate of pre-bankruptcy settlements at the beginning was attributed to the fact that it involved companies that have been operated at a loss for a long period of time, and became over-indebted, because their business and restructuring plans were of low quality. They are also faced with the higher financing costs because of the higher credit risks, and higher risk aversion by the banks. Therefore, corporate sector performances as well as the position of creditors with secured claims may be improved only after improvement in the operational results of the restructured corporates. In the medium term, they are expected to give results, but only in cooperation of both, banks and companies in terms of writing of share of the claims.

Chart 18: Coverage of NPLs by total reserves and NPL ratio, Croatia (in %)

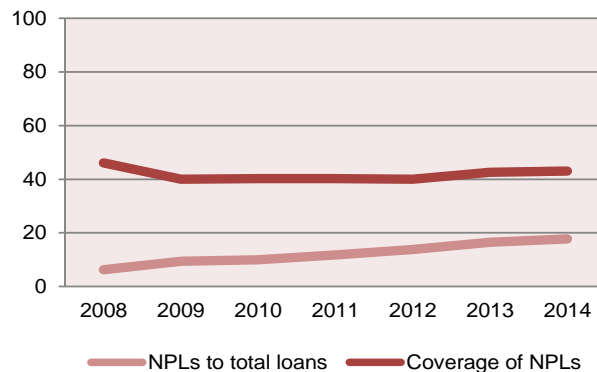


Italy

Italian banking sector experienced high rise in NPLs, up from 4.5% at the end of 2007 to 17.7% at the end of 2014. The rapid rise reflects in part the prolonged recession which has worsened the creditworthiness of borrowers, particularly SMEs that became heavily indebted. At the same time, the inefficient and lengthy judicial process, combined with the limited incentives to write off loans, has held back the pace of NPL resolution. The average provisioning coverage for Italian banks has declined from 48% in 2007 to a low of 37% at the end of June 2012. The Bank of Italy special loan inspections in preparation for the AQR, caused provisioning coverage to subsequently increase. In parallel, in 2013 regulation regarding tax regime changed creating greater incentives for banks to provisioning and write-offs. Still, provisioning coverage and write-offs are low, and do not keep up with the trend of the NPLs. The coverage ratio was 44.4% (for the five largest groups it was 46.6%). Coverage ratios of minor banks are lower than average because more of their lending is secured by collateral or personal guarantees. The diversity of the collateral provided by borrowers makes it much more difficult to estimate its value. The average time for writing off NPLs has increased to over six years.

Although there are some activities, the NPL market in Italy is still not developed. Italian banks tend to hold on to NPLs, while pursuing internal collection and loan restructuring efforts. The IMF has recommended following activities: accelerate provisioning and write-offs; improve further the insolvency regime; restart the NPL market; foster restructuring or resolution of distressed SMEs; promote alternative sources of financing; enhance the use and enforcement of collateral.

Chart 19: Coverage of NPLs by total reserves and NPL ratio, Italy (in %)



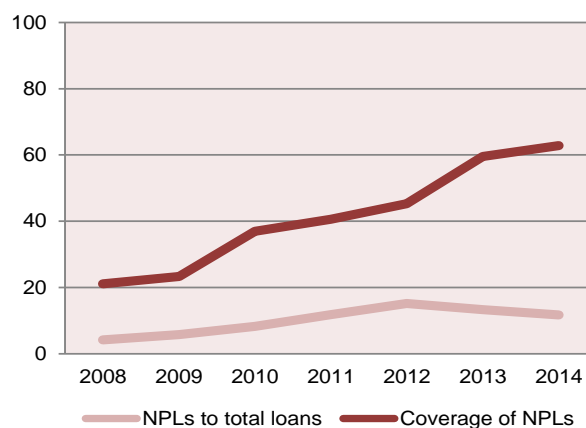
* Coverage for June 2014.

Slovenia

In *Slovenia* NPLs stood at 11.7% at the end of 2014, down from 15.2% in 2012 when they had peaked. Slovenian authorities established Bank Assets Management Company (BAMC) in March 2013 as a government-owned company. BAMC's mission is to: (i) stabilise the Slovenian financial sector through taking over NPLs from systemically important banks, (ii) promote confidence in the financial system, (iii) enable more focus on lending to good business, and (iv) facilitate and encourage sustainable corporate restructuring in Slovenia. The Bank of Slovenia's aimed also to expedite the write off of NPLs by allowing the banks to write off unsecured claims against debtors more than one year in arrears or in bankruptcy proceedings, and claims secured by real estate collateral more than four years in arrears or for which the bank in question did not receive any payment from the redemption of collateral over the same period. Despite this, there was no significant increase in write-offs, except during transfers to the BAMC. The quality of the credit portfolio remains unfavorable and represents income and insolvency risk for the banks.

With the intention of encouraging the banks to take a more active role in the restructuring of over-indebted but otherwise prospective corporates and the resulting improvement in the quality of the portfolio, the Bank of Slovenia drew up guidelines for creating impairments and provisions aimed at encouraging banks to gradually release impairments and provisions on restructured corporate exposures whenever Master Restructuring Agreement are reached with such clients. Corporates must consistently fulfil their obligations under such agreements as a condition for the release of impairments. As a micro-prudential measure, the aforementioned guidelines were coordinated in advance with the Slovenian Institute of Auditors and the audit firms that audit the banks. There were 30 such restructuring cases in November 2014. The most frequent forms of restructuring are the divestment of assets and/or operations, the extension of the deadline or deferral of the repayment of claims and conversion of claims into an investment in the equity in the debtor.

Chart 20: Coverage of NPLs by total reserves and NPL ratio, Slovenia (in %)



Real-economy challenges

The economy suffers from structural weaknesses. Significant bottlenecks to private sector activity stem from a lag behind peers in many aspects of the business climate that reduces incentives for investment. The structural and labor market rigidities have also contributed to persistently high unemployment, grey economy, low labor force participation rate, and relatively high reliance on remittances from abroad. In addition, significant resources are inefficiently used by public and socially owned enterprises. These enterprises represent an important share of the Serbian economy. The fiscal costs associated with these enterprises have been rising rapidly in recent years, amounting to more than 2 percent of GDP in 2014, and were concentrated in 7 companies. These costs have risen rapidly in the past few years mainly due to the worsening performance of the SOEs and could rise further if the underlying problems are not addressed. Additional direct fiscal costs arise from tax and social contribution arrears mainly among socially-owned enterprises. Furthermore, public enterprises give rise to indirect fiscal costs, which include implicit subsidies on borrowing costs due to issuance of state guarantees.

The Government initiated plans to embark on structural reforms with three broad priorities: job creation, improving the business environment and competitiveness, and resolution and reform of public and socially owned enterprises. In respect of the job creation, the Government took a key step in adopting amendments to the Labor Law in mid-2014 aimed at removing disincentives for hiring and making wage bargaining and employment procedures more flexible. Regarding the improving of the business environment, the Government is committed to a number of short and medium-term measures (these include, among others, implementation of the regulatory framework for unified procedure for issuing construction permits, final resolution of the issue of conversion of land-usage rights into ownership rights, adoption and implementation of a new Investment Law to enable efficient coordination of investment-related permits, etc.).

The Government has initiated broad-based structural resolve loss-making SOEs with the aim to foster Serbia's medium-term growth potential and reduce fiscal risks. Recent changes to the Bankruptcy Law and a new Privatization Law have created more effective tools needed to resolve non-viable state and socially-owned enterprises. New regulatory framework was followed by a significant reduction of state aid to these enterprises which is achieved by: curtailing direct and indirect subsidies, limiting issuance of new guarantees, and enhancing accountability, transparency and monitoring of these enterprises. The program was put in place which includes strategies for two broad categories of these enterprises. First, the authorities addressed companies in the portfolio of the Privatization Agency, most of which were protected under a bankruptcy moratorium until end-May 2015. For a small group of 17 companies with high privatization prospects, the moratorium was extended for up to 1 year in late May, and the Ministry of Economy will define in a Ministry Decision the deadlines for the resolution of individual companies within the extended timeframe. The remainder of the 500 enterprises in the portfolio of the Privatization Agency will be resolved through either privatization or bankruptcy, in accordance with the recently revised Privatization Law. Since August 2014, letters of interest for these companies have been collected, and we have adopted an action plan for bankruptcy procedures for 188 companies in early February 2015. As of end-May, court requests for bankruptcy proceedings have been submitted for 49 companies with little privatization prospects, public tenders for privatization of 12 companies were initiated. The authorities intend to finish the bankruptcy process of additional 139 companies by the end of 2015, and privatization procedures for an additional 80 companies under restructuring by end-October 2015, through either bankruptcy or privatization.

The second group includes large SOEs including the electricity, gas, railways, and road companies in case of which the authorities have started and are committed to restructuring in order to contain the additional fiscal costs that would arise without a change in policies. At the same time, adequate service provision will be ensured. To support the operation of the

telecommunication sector on a strictly market basis, a privatization tender for Telekom Serbia will be launched during the course of 2015. A management contract for Železara Smederevo, a steel producer, was signed with HPK engineering, a Netherlands-based company in March 2015. This has ensured the operation of the steel company without state aid this year—including budget subsidies, government guarantees, lending from the budget or any other forms of public support—and without further accumulation of arrears. At the same time, the authorities will continue to explore long-term concession partnerships for managing the Belgrade airport and operating Corridor XI.

To secure savings from the corporate and financial restructuring of major state owned enterprises, the Government introduced a number of public financial management changes. As a first step, on 22 April 2015 the Government adopted a Conclusion 05 No: 023-4473/2015 that regulates the roles and responsibilities of the Ministry of Finance, Ministry of Economy and line ministries with respect to monitoring, supporting best governance practices, financial reporting and transparency of SOEs. Quarterly provision of financial statements of SOEs to both the MOE and MOF was introduced from 2015. The public enterprises monitoring unit in the MOE which focuses on corporate strategy, governance and operational efficiency of these companies was strengthened. Finally, the public enterprises financial monitoring function was created in the fiscal risks management unit in the MOF, which focuses on reviewing and compiling the financial reports and statements of these companies and evaluates the fiscal implications.

VI FINAL PART

This Strategy shall be published in the "Official Gazette of the Republic of Serbia".