

NPL Resolution Strategy
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Executive Summary

Although banking sector in Republic of Serbia is well-capitalized and liquid, high and rising level of non-performing loans (NPLs) are increasingly burdening the banking sector, constraining lending activity and holding back higher growth rates. The rising trend in NPL since 2009 is a consequence of both macroeconomic and bank-specific factors (including weak internal organization, poor analytical capacity and lack of clear NPL management procedures).

Acknowledging the severity of the NPL overhang, the Serbian authorities, with assistance from the IFIs, are committed to support meaningful debt resolution by the private sector. To this end, the authorities have tasked a Working Group with the development of a comprehensive NPL resolution strategy that aims to, among others, (i) identify and remove impediments for meaningful debt resolution; (ii) strengthen incentives for viable but distressed debtors and creditors to participate in meaningful restructuring; (iii) ensure timely loss recognition; and (iv) prevent further accumulation of distressed debt in the Serbian banking system. The strategy comprises two action plans, i.e. one prepared by the Serbian Government and one prepared by the National Bank of Serbia (NBS) that, when implemented jointly, are expected to put NPL levels firmly on a downward trajectory.

The strategy encompasses the following areas.

- While the NPLs are inherent in the banking business, it is necessary to strengthen the **capacity of banks to resolve NPLs** on time and in optimal manner. The NBS will conduct special diagnostic studies (SDS) on representative sample of banking sector assets (14 banks) and following completion of SDS the NBS will assess modalities for fine tuning of the respective regulatory framework for banks. The NBS will also encourage conservative provisioning practices under International Accounting Standards; undertake supervisory and regulatory activities with the aim of strengthening regulatory treatment of restructured receivables and aspects of distressed loan management in banks; and enhance disclosure of asset quality.
- **Collateral valuation** in general has proved to be an insufficiently regulated area causing uncertainties regarding validity of valuations. To address this issue, the Ministry of Finance (MOF) will improve regulation of real estate appraisers and accuracy of real estate valuation by establishing transparent valuation criteria and standards, in line with international good practices. In addition, the NBS will develop a database, accessible to banks and appraisers, for detailed records on residential and commercial real estate valuations filed according to pre-established criteria.
- **NPL market development** would allow for more timely and efficient resolution of distressed assets and complements restructuring efforts by banks. The current Tax treatment of NPL write-off or sale and specific procedures may represent significant disincentives towards NPL resolution. In order to eliminate such disincentives, the MOF will consider (possibly temporary) legal amendments of current tax legislation, including regarding the recognition of write-offs for tax purposes and the tax implications of debt forgiveness for personal income tax purposes.
- Given the variety of factors behind the **slow pace of NPL market development**, especially in the area of tax, legal, capacity, data and other obstacles, a multipronged approach is necessary. Other aspects to be explored include potential impediments related to the establishment of privately-owned AMCs or other SPVs, and safeguards for the potential liberalization of NPL sale to investors and entities established outside of Serbia. Finally, the NBS will conduct a comprehensive analysis of modalities for a potential liberalization of the retail NPL market.
- The **Deposit Insurance Agency (DIA)** manages a large share of state-owned NPLs portfolio. However, the DIA resources and expertise are insufficient to conduct its broad mandate. To address this, the DIA in cooperation with the MOF, will develop a Strategic Plan for Asset Management and establish internal procedures, with the relevant capacity, for regular asset valuations and assessment of the recoverable value of the associated collateral. Further, the DIA will create a consolidated NPL team to strengthen the capacity for efficient resolution of its NPL portfolios.

- ***Out-of-court restructuring*** could foster speedy and orderly corporate workouts. In practice, consensual financial restructuring (CFR) is triggered too late – when the debtor’s financial condition is irredeemably impaired. To facilitate and incentivize CFR, the Ministry of Economy (MOE) will propose amendments to the existing CFR Law and relevant by-laws in cooperation with the Serbian Chamber of Commerce. The proposed changes will aim to streamline the CFR procedure, improve the framework for mediators’ participation, provide support for and promote awareness of the out-of-court restructuring framework, and provide a formal guidance for state creditors in the out-of-court financial restructuring.
- Many factors contribute to the inefficiencies of the ***enforcement framework***, including delays due to court-overloads, inadequate in-court asset appraisals, ineffective judicial auctions, and lack of interest to in-court auction sales. In addition, the auction rules for the sale of debtor’s property are somewhat rigid and disincentivising. To address these issues, the MOJ will consider changing the type of auctioning in corporate and entrepreneur enforcements (including mortgages) and consider transferring jurisdiction for all court enforcement cases against companies and entrepreneurs to Commercial Courts.
- While the ***bankruptcy framework*** has been expanded in the recent years with pre-packaged reorganization as a new restructuring option, experience indicates that they are mostly used as method to extend loan repayments without overall restructuring of the indebted company. Moreover, secured creditors struggle to effectively enforce their rights, in part due to significant delays in liquidation of secured assets. The MOE will prepare amendments to the Law on Bankruptcy to enhance safeguards for secured creditor’s rights, including through providing them greater control over decisions impacting their secured rights.. In addition, the MoE will propose additional rules for bankruptcy proceedings (e.g. related to the distressed group entities, protection of new financing in reorganization, revision of administrators’ fees the role of creditors in selecting bankruptcy administrators). Furthermore, there is a need to further strengthen capacities of the Bankruptcy Supervision Agency, and to enhance the courts’ handling of bankruptcy cases.
- The ***mortgage framework*** has just been amended. The previous framework had a number of inconsistencies and ambiguities, resulting in problems for mortgage enforcement. Identified constraints have been resolved via targeted amendments to the Mortgage Law adopted in July 2015. In addition to these amendments, it is needed to improve efficiency of mortgage registration, which could be delayed due to unresolved previous claims for changes in the Real Estate Cadaster. Establishment of a functional second-instance decision process for land registry case files is necessary along with identification of concrete land registries with large amount of unresolved files. On the other hand, improvements of the court enforcement procedure for mortgage activation and sale of secured asset, which is burdened with inefficiency of basic courts with jurisdiction for such procedures, is called for. Adequate protection of lower ranked mortgage creditors in out-of-court mortgage procedure should be ensured through proper valuation of mortgaged assets and open and transparent auction process.
- Finally, the need, feasibility, and timing of introducing a ***personal insolvency framework*** in Serbia will be carefully analyzed.

Implementation of the NPL resolution strategy is envisaged as a multi-year process, with the effectiveness thereof hinging on robust coordination among, and strong involvement of, all relevant stakeholders. The Working Group will be in charge of implementation monitoring, including the identification of any slippage and/or residual risks that warrant additional measures.