

New strategy for NPL resolution in Serbia: SEPTEMBER 2015

Where are we heading and what is important for potential investors?

The Government of Serbia has expanded its campaign to reduce systemic risk and unclog bank lending channels by adopting the Strategy for the resolution of non-performing loans (*Strategija za rešavanje problematičnih kredita*, "Official Gazette RoS", no. 72/2015, "**Strategy**"). The document was prepared jointly by the National Bank of Serbia ("**NBS**") and several ministries with the support from international financial institutions, including IMF and multilateral development banks. The Strategy, *inter alia*, contains an action plan that sets out a complex array of tasks to be carried out in the next few years. This provides an insight into how the regulatory framework will change and whether the change might spur interest from investors.

Potential size of the market

The Strategy reveals that the NPL ratio in Serbia amounted to 23% or around RSD 442.6 billion (€3.7 billion) at the end of April 2015.

Loans to "active" privately-owned companies make 52.5% of all non-performing loans (RSD 232.2 billion or €1.9 billion), whereas loans to the companies in insolvency proceedings amount to around 20% (RSD 88.5 billion or €737.5 million). Potential purchasers of these loans do not require a banking licence.

The notional value of non-performing retail loans exceeds RSD 71 billion (€590 million). These assets will remain out of the reach of prospective investors, given that the authorities have decided to put on hold the amendments to the laws that were supposed to allow sales to buyers other than Serbian-licensed banks and introduce personal insolvency.

Development of the market

The market activities have not picked up with the pace of regulatory relaxation. The Strategy

identifies some of the impediments and announces the following actions:

- **Tax treatment of write-off and sale of NPLs:** The Ministry of Finance ("MoF") will propose amendments to the corporate income tax regulations by the end of this year, allowing banks to recognise corporate loans' write-offs as expense for tax purposes without having to initiate court enforcement proceedings or wait for the insolvency of the debtor. This will be conditional upon the borrower being at least two years in arrears. The MoF has also undertaken to conduct a comprehensive analysis to identify and remove any potential additional tax impediments for sale of NPLs.
- **Substitution of the bank as plaintiff in the pending litigation:** The Ministry of Justice ("MoJ") will engage to enable purchasers of NPLs to step in instead of, or join, the seller bank as plaintiff in ongoing litigation. The position of the Commercial Court has been so far that the purchaser of the receivable has to initiate new proceedings. By June 2016, the MoJ will either propose amendments to the civil procedure law or advocate for a different and uniform interpretation of the existing rules by the competent courts.
- **Deposit Insurance Agency and asset management vehicles:** Pursuant to the [latest amendments to the Banking Act](#) (*Zakon o bankama*, "Official Gazette of RoS" Nos. 107/2005, 91/2010 and 14/2015), the NBS is authorised to transfer the assets, rights or liabilities of a bank under resolution to the Deposit Insurance Agency as the resolution authority ("DIA") or to one or more asset management vehicles. The DIA is already holding a significant amount of non-performing loans taken over from the failed state-owned banks. The Strategy obliges the DIA to improve the management and disposal of these assets. The preparation of a separate action plan, as well as the education and training of the staff, are scheduled for the 2016. In addition, the MoF will continue to analyse the possibilities for the establishment of asset management vehicles and the manner in which these entities would operate.
- **Valuation and Execution of Collateral:** The Strategy recognizes that the real estate appraisals have to be conducted in accordance with the best international practices. To that end, the status, tasks and responsibilities of professional appraisers will be regulated by a new law, which is expected to be adopted by the end of this year. The NBS will create a database containing the appraisals of the mortgaged real estate, which shall be available to the appraisals and banks. This should help the banks to make more accurate predictions of future cash flows from mortgage loans and improve provisioning standards. Finally, one of the measures announced by the Strategy has already been implemented - the [latest amendments to the Mortgage Act](#) (*Zakon o hipoteci*, "Official Gazette of RoS" Nos. 115/2005, 60/2015 and

63/2015 – decision by the Constitutional Court) abolish the provision that stipulated that lower-ranked mortgage survives the foreclosure on a higher-ranked mortgage.

Diagnostic studies

In the short run, the most significant element of the Strategy will be a comprehensive assessment of 14 banks. The Strategy confirms that the capital adequacy ratio (CAR) in the Serbian banking sector is at comfortable 19.4% (*cf.* the Basel III minimum CAR of 8% and the 12% CAR proscribed by the NBS). However, the components of the CAR calculation are dependent on the banks' internal assessments of the credit quality of their loan portfolios and those assessments are not necessarily accurate and objective. The NBS has therefore engaged external auditors and real estate appraisals to analyse the banks' balance sheets, the value of collaterals and the adequacy of provisioning. The process, labelled "diagnostic studies", resembles the Asset Quality Review program conducted by the ECB. The NBS has announced that it would apply the same methodology used by its European counterpart. The studies are expected to be completed shortly, but it is currently unclear whether the reports will be made accessible to the public. If capital shortfalls are revealed in certain banks as a result of loan misclassifications and inadequate provisioning, this could lead to a new cycle of M&A activities in the banking sector or, at least, induce the stressed banks to dispose of their non-performing assets.

Other notable announcements

The Strategy vouches to push for higher efficiency of court proceedings (litigation, enforcement and insolvency), and increased use of consensual out-of-court restructuring. The list of measures include stronger protection of secured creditors, expedition of sale of collaterals and training and education of judges and mediators. Finally, the Strategy highlights the need to increase the capacity of real estate cadastres in major cities in Serbia and thus quicken the establishment of mortgages.

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