

Serbia: Amendments to the Banking Act to ensure financial stability

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The latest amendments to the Banking Act (*Zakon o bankama*, "Official Gazette of RoS" Nos. 107/2005, 91/2010 and 14/2015), which come into application on 1 April 2015, introduce momentous changes to the regulatory framework governing supervision of banking institutions. Given the sheer number of the amendments, one wonders why the legislator did not instead adopt an entirely new banking legislation or a special law on the consolidation of the banking sector.

Partial Harmonization with the European Union Regulation

The primary aim of the amendments is to provide for regulatory and supervisory tools to deal efficiently with unsound or failing banks. In this respect, the amendments reflect to a great extent the provisions of the Bank Recovery and Resolution Directive (EU Directive 2014/59/EC, "**BRRD**").

Prevention

All banks will be required to prepare and maintain detailed recovery plans ("*plan oporavka*") stipulating the measures to be taken by a bank in order to restore its financial position and long-term viability in a situation of significant deterioration of its financial position, including undercapitalization.

While the amendments refer to the content of recovery plan only on a high-level basis, detailed mandatory elements of such plan are supposed to be elaborated in the implementing by-law. The National Bank of Serbia ("**NBS**") is entitled to review and approve the recovery plans. It may order a bank to submit a revised plan within two months. Serbian-licensed banks are required to submit to NBS the first recovery plans until 30 September 2015.

Early Intervention

NBS is now vested with the power to apply supervisory measures not only following an actual regulatory violation, established in the course of a diagnostic inspection of the bank and/or a trustworthiness and compliance control, but also in case it is *likely* that the bank will commit a breach in the near future in light of the fast deterioration of its financial position or an increasing level of indebtedness, non-performing loans or concentration of exposures.

Early intervention actions include implementation of measures set out in the recovery plan, convocation of shareholders' assembly, change of business strategy and preparation of a restructuring or disposal plan. In case of a serious deterioration of the bank's financial position or a serious breach of law, the bank's management can be replaced with a special administrator.

A significant novelty introduced by the amendments is a new power of NBS to write-down capital instruments of a bank or convert them into equity. NBS may adopt a decision to this effect even before the bank undergoes the resolution proceedings. This is similar to the bail-in resolution tool (see below), the difference being that the pre-resolution write-down and conversion may only be performed in relation to the bank's Tier 1 and Tier 2 capital whereas the bail-in resolution tool is, in principle, applicable to all liabilities of the bank under resolution. The consent of shareholders, creditors or debtors of the bank is not required.

Resolution

NBS is responsible for drawing up and maintaining resolution plans ("*plan restrukturiranja*") for the banks licensed in Serbia. A resolution plan must *inter alia* contain details on how NBS would apply the resolution tools and how the critical functions of the bank would be preserved in case the bank meets the conditions for resolution. NBS is required to adopt a decision on the opening of resolution proceedings ("**Decision**") in the following cases:

1. The bank in question is failing or is likely to fail. Such determination may be made if: (a) there are reasons that would justify revocation of the banking license or such reasons are likely to occur in the near future; (b) the bank has or is likely to have in the near future more liabilities than assets; (c) the bank is or is likely to become illiquid in the near future; or (d) the bank requires extraordinary public financial support.
2. There is no reasonable prospect, taking into account all relevant circumstances, that any alternative action by the bank or a private sector person would prevent the failure of the bank within a reasonable timeframe.
3. The resolution action is necessary and in the public interest. Public interest in such action exists if the bank is systemically significant or the action is necessary for the achievement of, and proportionate to, the resolution objectives and the same result would not be obtainable if the bank went into regular insolvency or liquidation proceedings.

The Decision must *inter alia* specify which of the following resolution tools will be applied by NBS:

- 1) **the sale of business tool** ("*prodaja akcija, odnosno imovine i obaveza*"); - NBS may transfer to a purchaser that is not a bridge institution: (a) shares issued by the bank under resolution or (b) all or

any assets, rights or liabilities of such bank.

2) **the bridge institution tool** (*“prenos banci za posebne namene”*) - NBS may transfer to a bridge institution: (a) shares issued by the bank under resolution or (b) all or any assets, rights or liabilities of such bank.

Bridge institutions (*“banka za posebne namene”*) shall be established by the Republic of Serbia for the purpose of maintaining the critical functions of a bank under resolution and selling the transferred assets at a later stage. Bridge institution is subject to a special bank license. The “lifetime” of a bridge institution is limited to two years, subject to the possibility of for an additional year under certain conditions.

3) **the asset separation tool** (*“odvajanje imovine”*) - NBS may transfer the assets, rights or liabilities of a bank under resolution to the Deposit Insurance Agency (**“DIA”**) or to one or more asset management vehicles.

Asset management vehicles (*“društvo za upravljanje imovinom”*, **“AMV”**) are supposed to be established by the Republic of Serbia for the purpose of receiving some or all of the assets, rights and liabilities of one or more banks under resolution or bridge institutions. AMVs acquire non-performing loans and other impaired assets which is why such institutions are commonly referred to as “bad banks” even though they do not hold a bank license. AMV shall manage the assets transferred to it with the aim of maximizing their value through sale.

4) **the bail-in tool** (*“raspodela gubitaka na akcionare i poverioce”*) - NBS may: (i) recapitalize a bank under resolution to the extent sufficient to restore the bank's ability to operate smoothly and sufficient market confidence in the bank; (ii) convert to equity or reduce the principal amount of claims or debt instruments which are transferred either to a bridge institution with the purpose of providing capital for that bridge institution or under the sale of business tool or the asset separation tool. The bail-in tool is a completely new resolution mechanism in Serbian law. The main idea behind the concept is to reduce the public spending and reallocate the expenses to the shareholders and the creditors of a bank under resolution. The method entitles NBS to write-down the eligible liabilities or convert them into equity so that the bank can continue as a going concern. The shareholders may become either diluted or completely wiped out in the process as a result of cancellation of their shares, transfer of the shares to the affected creditors or decrease of the nominal value of the shares.

Eligible liabilities (*“podobne obaveze”*) encompass all of the bank's liabilities except the deposits protected by the deposit guarantee scheme, secured liabilities, client assets, short-term inter-bank lending with an original maturity of less than seven days, claims of clearing houses and payment and

settlement systems with the remaining maturity of less than seven days, salaries, pensions, taxes and other levies. NBS may decide on an *ad hoc* basis to exclude other liabilities subject to certain requirements set out in the law.

NBS may apply all resolution tools either individually (except for the asset separation tool which must be used with another tool) or in any combination. In either case, the consent of shareholders, creditors or debtors of the bank under resolution is not required.

The costs of restructuring is born by the bank's shareholders and creditors, as well as by the deposit guarantee funds (*"fond za osiguranje depozita"*) and permitted state aid, subject to certain requirements. The deposit guarantee funds will be available if the resolution actions ensure that depositors will continue to have access to their deposits held by the bank under resolution. The contribution of this source of resolution financing is capped at the amount of losses the deposit guarantee fund would have to cover if the bank were wound up in regular insolvency or liquidation proceedings, but in any case may not exceed 50% of the resources available to the fund. It is worth noting that under the new Deposit Guarantee Act (*Zakon o osiguranju depozita*, "Official Gazette of RoS" No. 14/2015, "DGA"), the amounts that need to be contributed by each Serbian-licensed bank remain at the same level, although the deposit guarantee fund now has to cover an additional contingent liability. This means that the state will remain exposed to further public spending in case of deterioration of the bank's` financial positions, which is contrary to the aims of BRRD and the Banking Act. Unlike the BRRD, the Banking Act does not provide for resolution financing arrangements, *i.e.* it does not prescribe additional mandatory contributions by the industry. Another departure of the Banking Act from the BRRD is that it does not prescribe a minimum level of losses that must be covered by the shareholders and creditors of the bank under resolution before tapping into the public funds.

Capital & Risk

All banks will have to meet, at all times, a minimum requirement for own funds and eligible liabilities (*"minimalni zahtev za kapitalom i podobnim obavezama"*). Each Serbian-licensed bank shall *inter alia* be required to build a sufficient amount of eligible liabilities that may be converted into equity through the application of the bail-in tool, so that the mandatory capital adequacy ratio is maintained and the bank is able to continue as a going-concern and preserve adequate level of market confidence. NBS is supposed adopt a by-law stipulating additional criteria on the basis of which the minimum requirement for own funds and eligible liabilities shall be determined. Given that the Serbian-licensed banks are not accustomed to the contingent capital, this new capital requirement could prove to be a challenge.

The amendments introduce certain changes that could have a notable impact on the endeavours to resolve the issue of non-performing loans`. Namely, NBS is supposed to adopt by-laws regulating the manner in which the banks will monitor the quality of collateral and the performance of employees who monitor the quality of collateral. They also set out the situations in which the banks are obliged to write-off certain balance sheet and off-balance sheet assets. Finally, banks have a new obligation - to identify, measure and manage the risk of investment in real property (*investicione nekretnine*). Audit experts should be consulted in order to estimate whether and to what extent any real estate acquired by a bank as a result of a foreclosure on a loan qualifies as investment property pursuant to IAS 40. The total investment into working capital, investment property and entities which are not financial institutions may not exceed 50% of the bank`s capital.

Corporate Governance

The amendments provide that the executive board of a bank shall be liable for preparation of the risk management strategy and policies for the management board`s approval. The executive board then implements these strategy and policies and report to the management board thereon. In addition, the executive board is obliged to analyse the risk management system and submit to the management board regular quarterly reports on the bank`s exposure levels and the effects of risk management.

The management board of a bank is charged with the duty to adopt the above described recovery plans.

Banking Secrecy

The amendments to the Banking Act impose detailed confidentiality obligation on various involved parties pertaining to the trustworthiness and compliance controls and resolution of the bank. The duty of confidentiality survives the termination of employment or other engagement or capacity under which the listed persons have received confidential information. The described rules are subject to the equivalence assessment of the Serbian confidentiality legal regime and secure cooperation between the national, EU and other relevant counties` participants in the banking resolution processes.

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