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Finance

The Serbian NPL market feels the heat as investors pay increased attention to the region

OCTOBER 2016

The health of the banking sector in Serbia

European banks are still coping with the challenging environment defined by, among other issues, the high level of impaired assets and mounting regulatory pressure to remove these from the banks' balance sheets. Although, on average, the NPL ratios and provisioning are improving, there are still a significant number of financial institutions, in particular in the Southern part of the Euro-zone area, which have experienced a worsening in their asset quality since last year. The ECB has been advocating for more effective NPL management, prompting banks to dispose of their bad debt and in certain cases imposing strict deadlines to do so.

Serbia has its own share in the European NPL pot. According to the latest reports of the National Bank of Serbia ("**NBS**"), the average NPL ratio has decreased moderately and now amounts to 20.2 per cent. On average, the capitalization of Serbian banks is reassuring, as the industry's capital adequacy ratio remains at a high level of 21.6 per cent. These figures are, however, based on self-assessment and reporting conducted by the banks themselves. An asset quality review performed by the NBS in the course of 2015 showed that material exposures had been misclassified. In addition, the report was flattered by the participation of only the 14 biggest, out of a total of 30, banks operating on the Serbian market. Given the large divergence in performance, capital structure, and reporting standards across the sector, the overall capital adequacy ratio of the Serbian banking sector would likely be lower if more banks were included in the review. The new banking resolution tools of the NBS (including the power to order the carve-out and sale of non-performing loans without the consent of the bank's shareholders and management) have not yet been used.

Regulatory activity

The Government of Serbia, the NBS and other designated stakeholders have started implementing a robust Strategy for the resolution of non-performing loans (*Strategija za rešavanje problemati?nih kredita,* "Official Gazette RoS", no. 72/2015, "**Strategy**"). In July 2016, the new Enforcement and

Security Act became applicable, marking the beginning of a campaign to curtail lengthy judicial proceedings. Next in line for improvement are laws regulating litigation and insolvency procedures. The draft amendments to the Insolvency Act are directed at strengthening the position of secured creditors through their increased involvement in the decision-making process, and improvements in the protection of their rights and interests in collateral. In addition, the proposed changes should make the court reorganization process more efficient, and the conditions for financing a company under insolvency will also be enhanced (special creditor rights and priority for post-petition loans are provided in the draft law). At the same time, the requirements for write-offs have been relaxed, in order to motivate banks to remove bad debt from their balance sheets. The rules on the sale of non-performing assets have been amended to allow transfer loans classified as "problematic" although the debtor is not in default. However, the sale of retail loans to other non-banking entities is still prohibited. This may change, as the NBS has announced that "non-depository financial institutions" ("**NDFI**") will be allowed to purchase these assets. The regulatory framework for the establishment and operation of NDFIs is yet to be put in place.

Market infrastructure

The existing and future players on the market of ancillary activities face a number of obstacles. Questionable loan documentation, for example, not only hinders the due diligence process in the pre-investment stage, but also creates implementation problems for servicers. Although sophisticated servicers are becoming more adept in extracting information from external sources, poor quality of data maintained by many of the sellers remains a challenge. The protracted debt enforcement and foreclosure proceedings are also among the standout issues virtually across South East Europe. In Serbia, the demand for the providers of advice and support in the loan recovery processes is especially expected to surge following the anticipated increase in NPL transaction volumes.

BDK Serbia
Majke Jevrosime 23
11000 Belgrade
Tel: +381 11 3284 212
Fax: +381 11 3284 213
office@bdkadvokati.com

BDK Montenegro
Bul. Džordža Vašingtona 51
81000 Podgorica
Tel: +382 20 230 396
Fax: +382 20 230 396
office.cg@bdkadvokati.com

BDK Bosnia and Herzegovina (Advokat Dijana Pejić u saradnji sa BDK Advokati AOD)
Gundulićeva 6
78000 Banja Luka
Tel: +387 51 250 641
Fax: +387 51 250 642
office.banjaluka@bdkadvokati.com