

# PROJECT INFORMATION DOCUMENT (PID) CONCEPT STAGE

Report No.: PIDC2446

<b>Project Name</b>	Deposit Insurance Strengthening Project (P146248)
<b>Region</b>	EUROPE AND CENTRAL ASIA
<b>Country</b>	Serbia
<b>Sector(s)</b>	Banking (50%), Public administration- Financial Sector (50%)
<b>Theme(s)</b>	International financial standards and systems (100%)
<b>Lending Instrument</b>	Investment Project Financing
<b>Project ID</b>	P146248
<b>Borrower(s)</b>	Republic of Serbia
<b>Implementing Agency</b>	Deposit Insurance Agency of Serbia
<b>Environmental Category</b>	C-Not Required
<b>Date PID Prepared/ Updated</b>	25-Dec-2013
<b>Date PID Approved/ Disclosed</b>	26-Dec-2013
<b>Estimated Date of Appraisal Completion</b>	17-Jan-2014
<b>Estimated Date of Board Approval</b>	27-Feb-2014
<b>Concept Review Decision</b>	Track II - The review did authorize the preparation to continue

## I. Introduction and Context

### Country Context

The global financial crisis that began in 2008 prompted the need for fiscal consolidation and the acceleration of the unfinished transition to a market economy in Serbia. The rapid growth experienced by Serbia during 2004-08 was driven mainly by domestic consumption and resulted in significant internal and external imbalances, which proved unsustainable. The economy contracted by 3.5 percent in 2009 and after a weak recovery in 2010 and 2011, contracted by 1.7 percent again in 2012. The crisis unearthed key structural weaknesses and obstacles that hamper sustainable economic development, including a pervasive influence of the state on the economy and financial sector, and an unfavorable business environment with cumbersome administrative procedures. The sluggish economic performance in the country since the onset of the global financial crisis was accompanied by a deterioration of Serbia's fiscal stance and a rapid increase of public debt, which doubled between 2008 and 2012 to reach some 60 percent of GDP.

The crisis also resulted in a deterioration of the living conditions in Serbia with poverty and

unemployment rising steadily since 2008. In 2010 (the last year for which official poverty data have been released), poverty reached 9.2 percent (from 6.1 percent in 2008. Staff estimates using a micro-simulation model suggest that by 2011 poverty levels might have climbed to over 11 percent. Despite recent minor improvements, unemployment remains high - it was estimated at 24.1 percent (26.5 for women and 22.3 percent for men) for individuals of age 15 and over in April 2013 (rising from 19.2 in April 2010).

The government has shown a renewed commitment to an ambitious economic reform agenda. Since early 2013, the authorities have embarked on an ambitious program of fiscal consolidation and structural reforms to create conditions for economic recovery, long-term sustainable growth, and improved living standards. The government program for 2014-2016 will focus on ensuring economic and financial stability, stopping further debt accumulation and creating an environment for economic recovery and growth to foster employment and raise living standards. These goals will be achieved primarily through fiscal consolidation measures and acceleration of structural reforms to remove existing bottlenecks to economic growth, including strengthening the financial sector.

The government has also demonstrated a strong commitment to the EU accession agenda. As part of this agenda, the government makes a considerable effort in accelerating the preparation process for the EU accession, including initiating discussions on critical issues such as justice sector reforms and the rule of law. The results of the recent poll, conducted by the Serbian Intelligence office in July 2013, suggest that support for EU membership in the country has reached 50 percent, which is 9 percent higher than in January 2012.

### **Sectoral and Institutional Context**

The financial sector in Serbia is dominated by the banking sector, which accounts for 92 percent of financial sector assets and for about 85 percent of the country's GDP. As of December 2013, there were 31 banks operating in Serbia. About 75% of the assets of the banking sector are controlled by European owned banks, and there are 12 domestic banks that control the remaining banking sector assets.

The financial sector in Serbia grew rapidly until 2008. From 2004 to 2008, credit to private sector grew at an average annual nominal rate of about 31 percent (after accounting for exchange rate developments). Credit to the private sector doubled from 20 percent at end-2003 to 41 percent at end-2008 as a share of GDP. With confidence in banking sector gradually rebuilding, this was also reflected in deposits growth: household deposits increased from negligible EUR 352 million in December 2001 to EUR 5.64 billion in September 2008.

With the onset of the first wave of crisis in late 2008 financial activity slowed down sharply, but the outright credit crunch was avoided and banks weathered the crisis. Confidence in the banking sector was affected and almost 20 percent of household deposits were withdrawn in the fourth quarter of 2008. Nonetheless, a conservative regulatory approach had left the banking system with capital and liquidity buffers large enough to withstand these shocks.

Confidence was restored through a coordinated response by the NBS and the Government, in close cooperation with the banking community, IFIs, and the European Union, under the Vienna initiative and its more recent successor. With large presence of foreign banks in the country, ensuring that they remain committed to the Serbian market was paramount. To this end, the Government implemented a program under the auspices of the "Vienna initiative" in late 2008. Further, to ensure

that the system was well capitalized a bank diagnostic and triage exercise was implemented by NBS in late 2009, resulting in recapitalization of several banks. Also, the deposit insurance fund was strengthened by increasing the insured deposit coverage from EUR 3,000 to EUR 50,000. Finally, to deal with problem banks in a more effective and less costly manner, the existing bank resolution framework was over-hauled. As a result of these measures, confidence gradually returned, for example, household deposits stabilized in early 2009, and have been growing since and are now at a record level of EUR 7.5 billion.

Growth of credit to private sector has also slowed down following the crisis and has stifled economic growth. Credit to the private sector has averaged an annual nominal rate of about 11 percent (after accounting for exchange rate developments) over the last three years. This credit growth in recent years has also been supported by various Government programs of subsidized loans. That said, cross-border loans to companies have reversed (prior to the crisis, stock of cross border credit to companies exceeded stock of credit to companies through the domestic banking system), as companies are now, on a net basis, repaying their cross-border loans. Thus, taking these flows into account, there was virtually no growth of credit to companies in the prior three years.

Asset quality has deteriorated substantially since late 2008 and poses risks to the banking sector. The weak economic recovery and high unemployment rates, coupled with large depreciation and consequent increase in debt service of FX linked loans, has caused a significant increase in NPLs. Gross NPLs have almost doubled, from 10.2 percent of total loans in third quarter of 2008, to slightly over 21% by mid-2013 (Figure 1). However, in response to the rise in NPLs, Serbian Banks have increased provisions to cover these losses. The levels of provisions to NPLs have been declining from 156.3 in 2008 to 115.9 in June 2013 but are still significant to compensate for such losses.

The Serbian banking sector is stable overall. Serbian banks, as a whole, are well-capitalized, with capital ratios that continue to exceed 20% in the second quarter of 2013. The ratio of bank capital to assets, which is a measure of bank solvency and resiliency, shows the extent to which banks can deal with unexpected losses. Serbian banks are also liquid, with core liquid assets/total assets also over 20%. This demonstrates that Serbian banks are well positioned to deal with any shocks due to their ability to access liquid assets. This analysis is consistent with the latest IMF Article IV from June, 2013, which also states that the banking sector overall is stable.

However, there are some vulnerabilities that remain a concern. Although NPLs appear to be well provisioned, deterioration in economic conditions could lead a further decrease in asset quality. In addition the failure of Agrobanka and RBV has resulted in the depletion of the Deposit Insurance Fund (DIF) which poses risks to the stability of the system if there is another bank failure in the future.

### **Relationship to CAS**

The FY12-15 Country Program Strategy (CPS) included a focus on strengthening the financial sector as part of the competitiveness pillar. A well-developed financial sector is critical to the overall competitiveness of an economy, as it helps to mobilize savings and channel them for the most productive uses. In order to accomplish this goal, the CPS included World Bank analytical work in the financial sector and several IFC investments.

The CPS did not include the proposed lending operation for strengthening the Deposit Insurance

Agency as part of the lending program envisaged. The request for financial and technical support for the Deposit Insurance Agency was sent to the World Bank on June 7, 2013. Considering the urgent need to support for the Deposit Insurance Agency, the World Bank has agreed to include this proposed operation in its lending program for FY12-15. The CPS mid-term progress report is in the process of being prepared and will include this operation as part of the World Bank's activities aimed at achieving the goals of the competitiveness pillar.

## **II. Proposed Development Objective(s)**

### **Proposed Development Objective(s) (From PCN)**

The Project Development Objective is to strengthen the financial capacity of the DIA so as to meet its legal deposit insurance and bank resolution obligations.

### **Key Results (From PCN)**

The current PDO will be assessed based on:

- (i) achieving financial inflows into the DIF that are sufficient for it to have the financial capacity to meet its legal deposit insurance and bank resolution obligations
- (ii) the DIA performing its legally mandated deposit insurance and bank resolution functions in 100% of bank failures (if any)

## **III. Preliminary Description**

### **Concept Description**

The proposed project is a Results Based IPF to the Republic of Serbia for an amount of US\$200 million to support the strengthening of the Deposit Insurance Agency (DIA). The recent failure of two small banks resulted in the depletion of a key part of the financial safety net, the Deposit Insurance Fund (DIF). The Deposit Insurance Fund of Serbia is managed by the Serbian Deposit Insurance Agency (DIA), which utilizes the financial resources available to protect depositors up to a specified level (in this case EUR 50,000) and to facilitate the resolution of banks that fail in a cost effective manner. Considering the importance of an effective Deposit Insurance Scheme to maintaining confidence in the banking system, this operation aims to provide the Deposit Insurance Fund with the financial resources required to perform its legally mandated deposit insurance and bank resolution functions.

The proposed project has two components:

- 1) A results based component of US\$199 million that capitalizes the Deposit Insurance Fund based on satisfactorily achieving DLIs that improve the ability of the DIA to meet its legally mandated deposit insurance and bank resolution obligations.
- 2) A technical assistance component of US\$1 million that aims to strengthen the ability of the DIA to meet its legal deposit insurance and bank resolution obligations.

### **Component 1: Results Based Component**

This component includes US\$199 million that will be utilized to capitalize the Deposit Insurance Fund based on meeting Disbursement Linked Indicators (DLIs). The DLIs will be developed during the course of the project preparation, but examples of DLIs include the following:

- Increasing premiums from banks
- Putting in place a stand-by facility for the DIA
- Improving information sharing between the NBS and DIA
- Improving the independence of the Board of the DIA

- Improving the recoveries process
- Improving oversight of the State Owned Banking sector

#### DLI 1: Premiums

Considering that premiums are the primary source of income for the DIF, they will need to be increased to achieve the target size. The DLIs in this category will aim to increase the amount of premiums from the banks operating in Serbia in line with international best practices for a Deposit Insurance Scheme. These DLIs will increase the premiums (either through an extraordinary premium increase or an increase in the regular premium) from the current level of 0.4% in 2014 and 2015 as Deposit Insurance Schemes should primarily be paid for by the banks themselves.

#### DLI 2: Stand-by facility

In addition to funding, it is critical for the DIA to have a guarantee or stand-by facility that it can readily access in case it runs out of funds. Best practice for Deposit Insurance Schemes includes having a back-up facility that ensures that funds can be accessed without Government approval during a time of banking instability. Thus the second DLI will ensure that the Government puts in place a guarantee or stand-by.

#### DLI 3: Improved information sharing between financial safety net providers

In order to strengthen the coordination between the three financial safety net providers, DLIs will target the sharing of key data between the NBS to the DIA. The sharing of information between the financial safety net providers is critical to allowing the DIA to meet its legally mandated function. International best practices require that a framework should be in place for the close coordination and information sharing. This should be done on a routine basis, as well as in relation to particular banks, among the deposit insurer and other financial system safety-net participants

#### DLI 4: Increasing the independence of Board of Directors of the Agency

Governance principles for deposit insurers highlight that it should be operationally independent, transparent, accountable and insulated from undue political and industry influence. The DLIs in this category will aim to increase the independence of the Board of Directors of the Agency. The current governing body of the Deposit Insurance Agency is its Managing Board. The Deposit Insurance Law indicates that the Managing Board is to be comprised of six members: a Chairman appointed by the Government; the Minister of Finance and Economy; the Vice-Governor of the NBS responsible for bank supervision; the Deputy Director of banking supervision at the NBS; a member from the Association of Banks; and a member proposed and appointed by the Government.

#### DLI 5: Strengthen the results from the recovery process.

The Deposit Insurance Agency's mandate also includes collecting receivables from bank bankruptcies and liquidations. Collections from these efforts totaled only EUR 40 million in 2011 and 2012, as there are issues related to both the institutional and legal structure for conducting these transactions that minimize the likelihood of success. Thus, the DLIs in this category will focus on implementing a strategy (exact targets to be defined during project preparation)

#### DLI 6: Improving oversight of State Owned Banks

There is a need to improve the information flow from the state owned banks to the owner – which in this case is the Government – in order to minimize the possibility of future problems similar to Agrobanka and RBV that resulted in the depletion of the DIF. The Government currently has an ownership stake in seven banks, two of which have equity investments by EBRD and the IFC. DLIs

will aim to improve the information that the Government has on the State Owned Banks in order to better manage the assets in which it has an ownership stake.

Component 2: Technical Assistance to improve the ability of the DIA to meet its legally mandated deposit insurance and bank resolution functions.

This component will finance technical assistance in critical areas that are needed to achieve the DLIs. The exact nature of the TA can only be determined after finalizing the DLIS, but possible areas of TA include:

- Information sharing between safety net providers: Consulting services could be provided to ensure that the DIA has adequate capacity to utilize the information that it is provided from the NBS.
- Governance: Consulting services could be provided on developing an operational manual for the Board of the DIA and ensuring that it has the capacity to meet its legally mandated requirements.
- Recoveries: Consulting services could be provided to develop a time-bound strategy and implement it over the course of two years.
- Oversight of State Owned Banks: Consulting services could be provided to increase the capacity of the Ministry of Finance to oversee the enterprises that it manages and improve the corporate governance framework.

#### IV. Safeguard Policies that might apply

Safeguard Policies Triggered by the Project	Yes	No	TBD
Environmental Assessment OP/BP 4.01		x	
Natural Habitats OP/BP 4.04		x	
Forests OP/BP 4.36		x	
Pest Management OP 4.09		x	
Physical Cultural Resources OP/BP 4.11		x	
Indigenous Peoples OP/BP 4.10		x	
Involuntary Resettlement OP/BP 4.12		x	
Safety of Dams OP/BP 4.37		x	
Projects on International Waterways OP/BP 7.50		x	
Projects in Disputed Areas OP/BP 7.60		x	

#### V. Financing (in USD Million)

Total Project Cost:	200.00	Total Bank Financing:	200.00
Financing Gap:	0.00		
<b>Financing Source</b>		<b>Amount</b>	
Borrower		0.00	
International Bank for Reconstruction and Development		200.00	
Total		200.00	

#### VI. Contact point

**World Bank**

Contact: Rinku Chandra  
Title: Senior Private Sector Development Specialist  
Tel: 458-9671  
Email: rchandra@worldbank.org

**Borrower/Client/Recipient**

Name: Republic of Serbia  
Contact: Zlatko Milikic  
Title: Assistant Minister  
Tel: 381113642-741  
Email: Zlatko.milikic@mfin.gov.rs

**Implementing Agencies**

Name: Deposit Insurance Agency of Serbia  
Contact: Zoran Obradovic  
Title: Director  
Tel: 381112075100  
Email: zoran.obradovic@aod.rs

**VII. For more information contact:**

The InfoShop  
The World Bank  
1818 H Street, NW  
Washington, D.C. 20433  
Telephone: (202) 458-4500  
Fax: (202) 522-1500  
Web: <http://www.worldbank.org/infoshop>