# Project Information Document/ Integrated Safeguards Data Sheet (PID/ISDS)

Concept Stage | Date Prepared/Updated: 28-Dec-2017 | Report No: PIDISDSC16878

## BASIC INFORMATION

### A. Basic Project Data

| Country | Project ID | Parent Project ID (if any) | Project Name |
|---|---|---|---|
| Serbia | P156837 | | State Owned Financial Institutions Reform Project (P156837) |
| **Region** | **Estimated Appraisal Date** | **Estimated Board Date** | **Practice Area (Lead)** |
| EUROPE AND CENTRAL ASIA | Jan 22, 2018 | Mar 22, 2018 | Finance & Markets |
| **Financing Instrument** | **Borrower(s)** | **Implementing Agency** | |
| Investment Project Financing | Ministry of Finance of Serbia | Ministry of Finance | |

**Financing (in USD Million)**

| Financing Source | Amount |
|---|---|
| International Bank for Reconstruction and Development | 50.00 |
| Borrowing Country's Fin. Intermediary/ies | 6.00 |
| **Total Project Cost** | **56.00** |

| Environmental Assessment Category | Concept Review Decision |
|---|---|
| C-Not Required | Track II-The review did authorize the preparation to continue |

Other Decision (as needed)

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### B. Introduction and Context

Country Context

The global financial crisis that began in 2008 exposed weaknesses in the Serbian economy prompting a need to rethink the overall growth model for the country. The Serbian economy grew rapidly averaging 5.0 percent growth for 2001-2009 prior to the onset of the global financial crisis, fueled by domestic consumption and funded by significant capital inflows. This led to substantial external imbalances, with the current account deficit reaching over 20 percent of gross domestic product (GDP) in 2008. This demand-driven growth model was proven unsustainable in 2009, when real GDP fell by 3.1 percent, unemployment increased by 2.5 percent and total investment decreased to 20 percent of GDP from 25 percent in 2008. The crisis exposed the need to accelerate the incomplete transition to a market-based economy and address obstacles to development, including the significant role of the state in the economy and an unfavorable

business environment.

Following lackluster performance since the crisis, Serbia's economic growth is expected to pick up in the context of government consolidation and an ambitious structural reform program. In 2014, the economy fell into recession for the third time in six years, partially due to the devastating floods in May 2014. Real GDP recovered in 2015 with modest growth of 0.8 percent and stronger growth of 2.8 percent in 2016. Unemployment fell to 15.3 percent in 2016, after reaching a peak of 24 percent in 2012, reflecting the recent recovery in economic activity. Real GDP growth is projected to reach 4 percent by 2020, underpinned by a more supportive external demand, improved investment, and a gradual recovery of consumption. In the late 2014 the government has put in place an ambitious reform program that focuses on fiscal consolidation to ensure macroeconomic stability, improving financial sector stability and resilience, boosting competitiveness and ensuring sustainable growth. The new government, formed in August 2016, is committed to these reforms, along with pursuing accession to the European Union (EU). The program is supported by a three-year International Monetary Fund (IMF) Stand-by Agreement (SBA).

A key element of the government's reform program involves reducing the role of the state in the economy to boost competitiveness and decrease fiscal expenditures. The transition to a market economy began in earnest in 2001. Significant gains were made in the early years of the transition, with over 2,700 enterprises privatized. However, the state continues to play a large role in the economy. There are about 800 state-owned enterprises (SOEs) that employ about 10 percent (200,000 workers) of the formal Serbian workforce. These enterprises include public utilities, numerous commercial enterprises, and several state-owned financial institutions (SOFIs) that play a significant role in the financial sector. Many of these enterprises perform poorly, have weak governance and oversight, and are prone to politically influenced decision making. The prevalent role of the state in the economy creates significant distortions and misallocation of resources. Since SOEs have a major role in nearly every sector of the economy, private investment is crowded out and valuable labor, capital, and land are not allocated productively. De facto wage policy in many SOEs, although in principle related to the public wage salary scale, is relatively liberal and further distorts the already high public/ private wage ratio.

### Sectoral and Institutional Context

The Serbian financial sector is dominated by the banking sector with strong foreign bank presence. The banking sector accounts for 91 percent of financial sector assets. At the end of the second quarter in 2017, there were 31 licensed banks in Serbia, including 21 foreign-owned banks, mainly from Europe, 6 state-owned banks and 4 privately-owned domestic banks.

The Serbian banking system was hit hard by the global financial crisis in 2008 and suffered from weak performance for several years afterwards. In the aftermath of the crisis, the banking sector suffered from high non-performing loans (NPLs), low profitability and stagnant or declining credit conditions. NPLs as a share of gross loans grew from 11.8 percent in end 2008 to a peak of 23 percent in 2014 as a result of the reduced economic activity, rising unemployment, and local currency depreciation. Credit growth to the private corporate sector declined from 30 percent on annual basis in 2008 to negative 9 percent on annual basis in 2013. At the same time, bank profitability was eroded with average return to equity (ROE) of the banking sector declining from positive 9.6 percent in 2008 to a bottom of negative 0.4 percent in 2013. In spite of these developments, the system remained well capitalized during this period, with capital adequacy ratios exceeding 19 percent.

The performance of the banking sector has recently improved. Lending activity started recovering after 2014, aided by the accelerated economic recovery and low interest rate environment. Total private sector credit grew by 5.6 percent

in 2016. The authorities also took a number of measures to address high NPLs through the NPL Resolution Strategy, resulting in a significantly lower NPL ratio of approximately 15.6 percent as of end Q2 2017, its lowest level since June 2013 (Figure 1). Sector profitability steadily improved over the past years with ROE of 10.6 percent as of June 2017. The sector continues to be resilient, with an asset quality review (AQR) that was completed by the National Bank of Serbia (NBS) confirming that average capital adequacy exceeds 20 percent.

The Republic of Serbia has direct ownership stakes in four banks operating in Serbia: Komercijalna Banka, Banka Postanska Stedionica (BPS), Srpska Banka, and Jubmes Banka. It also has indirect ownership in MTS Banka and Jugobanka-Jugbanka Kosovska Mitrovica and in one savings bank, Tesla Banka, which operates in Croatia. The banks with ownership interest account for approximately 18 percent of assets of the Serbian banking system as of July 2017. Of the banks with state ownership, only Komercijalna Banka and BPS are considered to be of systemic importance.

***Role of the State in the Financial Sector***

In addition to state-owned banks, there are several other SOFIs in Serbia that play a significant role in the financial sector. It is estimated that SOFIs have a market share of about 18 percent in the total financial sector. In addition to the state-owned banks, the government has ownership interest in the largest insurance company, Dunav Insurance, and two development finance institutions (DFIs), the Development Fund and the Serbian Export Credit and Insurance Agency (AOFI).

Recognizing the material risks that exist in SOFIs, the government has developed a reform strategy for SOFIs and requested the World Bank's support via a results-based IPF to help implement this strategy. The reform strategy aims to divest from those SOFIs that the government has chosen not to retain, and improve the financial and operational performance of the remainder in order to minimize fiscal risks from SOFIs and ensure that soft budget support from SOFIs to the SOE sector in the form of loans in arrears is minimized going forward.

***Reform of State Owned Banks***

The major focus of the government's state-owned bank reform agenda is on ensuring the viability and sustainability of BPS. The government has chosen to retain BPS in the medium-term due to its importance for access to financial services in the country. Traditionally, BPS primarily served as a retail bank that had a vital role in access to finance with its large network of 130 branches and presence at 4,000 post offices. BPS has one of the largest customer franchises in Serbia with more than 2.8 million customers, including a large number who primarily utilize the bank as a means to obtain their pensions and other government social security payments. The bank has historically been a highly liquid, low risk bank, with limited lending operations.

BPS is a troubled bank that requires significant restructuring. From 2012 on BPS rapidly grew its corporate portfolio and also involuntarily acquired large amounts of corporate loans from failed banks, with the result that the bank rapidly reoriented itself from being primarily a retail lender to primarily a corporate lender. The expansion of the corporate lending portfolio was undertaken without first putting in place proper policies and procedures to manage the risks of large corporate lending which resulted in large credit losses, the majority of which were incurred on corporate loans originated by BPS itself. A combination of poor governance, poor risk management, and political interference in the lending decisions thus resulted in the rapid growth of corporate NPLs. Total NPLs were at 42 percent of gross loans by end-2016, with 95 percent of NPLs being corporate loans. In December 2016, BPS recorded a one-time impairment charge of about RSD 9 billion and suffered losses of RSD 6.3 billion as a result of recording provisions required to fully cover the credit risk of its corporate loan portfolio.

The government has prioritized restructuring BPS to minimize fiscal risk and develop a viable financial institution. In August 2016, the government adopted a conclusion on guidelines for the bank's new business strategy. This requires that the bank exit the medium and large corporate lending business, limit its lending to SOEs to a total amount less than the amount of public sector deposits at the bank, and focus on serving the retail and SME markets. The government conclusion also calls for improvements in the corporate governance and risk management systems in the bank, reduction of NPLs, and reorganization of the operations of the bank (e.g., HR, IT, etc.) in alignment with the new strategy. The key element of the strategy is that it puts in place an independent risk management function and pairs this with hard and rapidly declining ceilings on the corporate lending business and also caps lending to SOEs. Since end 2016, as a result of implementation of the government's conclusion, BPS has been able to reduce its level of net NPLs to net loans from 16.5 percent as of Q3 2016 to 4.9 percent as of Q3 2017. In December 2017, BPS formally adopted its new strategy and three-year business plan in line with the conclusion.

***Other State Owned Financial Institutions***

Other state-owned financial institutions include most importantly the Development Fund (DF) and AOFI. These non-deposit-taking financial institutions provide financial support to enterprises. The DF and AOFI have developmental mandates and provide direct loans, guarantees, export credit insurance, factoring, and export financing to enterprises. Together the gross loans and guaranteed portfolio outstanding on the balance sheets of these two institutions are equivalent to about 7 percent of total loans outstanding in the entire (commercial) banking sector. In addition, the DF channels considerable budget funds through off-balance sheet structures to borrowers.

The government is currently reviewing the institutional framework for providing developmental finance in Serbia. Although significant public resources are spent on financial support programs through the DF and AOFI, the current system is complex, non-transparent and inefficient. Limited oversight has resulted in shallow understanding on behalf of the government on the activities and performance of the institutions and limited accountability of the institutions themselves. Both institutions officially report to the Ministry of Economy (MoE) with no oversight by the NBS.

The government has also decided to establish a working group to identify options for providing development finance in Serbia. The goal is to identify the role and functions of development finance that would be suitable for the Serbian market and to propose what kind of changes are needed to align the current framework with the EU, and be able to maximize the potential of development finance without putting too much burden on the budget itself. The working group will also need to propose decisions on the future of the DF and AOFI and the need to create an appropriate supervisory framework, including application of strict asset valuation rules, disclosure of audited financial statements under IFRS, and an assessment of what institution is best positioned to exert oversight.

Given that NPLs have become a potential source of systemic risk, the authorities developed a comprehensive Strategy for NPL Resolution. Implementation of the strategy required complex inter-institutional coordination, and two action plans – one developed by the NBS and the other by the government of the RoS. The NPL working group consists of representatives of all relevant institutions, supervises the implementation of the strategy and identifies problems that should be addressed during implementation. The level of NPLs decreased significantly after the adoption of the strategy, and in the period of its implementation, both in nominal as well as in relative terms.

Based on the success of the NPL Resolution Strategy, the government is reviewing the need to systematically approach the issue of recovering bad assets from failed state owned banks and other SOFIs. To that end, the update of the NPL Resolution Strategy, which will take place in 2018, will include guidance on potential resolution mechanisms, the

current legislation and the need to amend or introduce new legislation to allow alternative approaches to accelerate and complete NPL resolution for state owned banks, failed state owned banks as well as non-banking financial institutions. The updated strategy should propose a model and provide a supplementing action plan that would resolve existing problems and enable the final settlement of creditors.

### Relationship to CPF

The financial sector results based IPF is fully congruent with the Country Partnership Framework (CPF) for FY16-20 focus areas (Focus Area 1: the "Economic governance and the role of the state" and Focus Area 2: "Private sector growth and economic inclusion"). Focus area 1 specifically addresses constraints to the effectiveness of economic governance, including those related to the government's role in the financial sector as the owner of key institutions. This project will directly contribute to the goal of supporting sustainable public expenditure management in this CPF area. Focus area 2 addresses significant constraints to private sector development and economic inclusion, including those related to the financial sector. This project will directly contribute to the goal of assisting in creating a more stable and accessible financial sector.

## C. Proposed Development Objective(s)

The Project Development Objective is to support the reform of State Owned Financial Institutions.

### Key Results (From PCN)

The PDO indicators include the following:

- BPS in compliance with all prudential ratios
- BPS net corporate NPLs are reduced compared to end-2016
- State-owned NPLs are reduced compared to end-2016

These PDO level indicators are underpinned by a series of disbursement-linked indicators (DLIs) that will be utilized to facilitate the achievement of project objectives, as well as intermediate results indicators

## D. Concept Description

The project includes two components that support the authorities in implementing their reform program for SOFIs:

1. A results-based component of US$35.6 million that supports the reform of SOFIs based on the achievement of DLIs in line with the government's reform program;
2. A technical assistance and investment component of US$14.4 million that aims at strengthening institutional capacity and finances needed goods and services to support the achievement of DLIs.

Under both components, the project focuses on supporting the government in two major elements of its reform program: (i) restructuring BPS, which is the core part of the government's state-owned banking sector reform strategy; and (ii) supporting the MoF in improving the oversight of SOFIs, implementing the government's strategy

for state-owned banks, divest from SOFIs that were not decided to be retained, develop a forward-looking strategy on development finance, and continue to make progress on the resolution of NPLs.

**Component 1: Support the Reform of State Owned Financial Institutions (US$35.6 million)**

Under this component, evidence of achievement of a series of DLIs in the two reform areas supported by the project will be required prior to reimbursing eligible expenditures. A summary of the DLIs is included below.

1. Restructuring BPS. Given the government's decision to retain BPS in the medium term, the bank needs to be restructured in order to reduce fiscal risks and enhance its performance. The results-based component will include DLIs that support the implementation of the governments' conclusion on BPS, which involves reorienting the bank towards retail and micro and small business lending in line with both the Government conclusion and a new business plan, while exiting the corporate lending to large and medium businesses, decreasing its operations with SOEs, and reducing its stock of NPLs.
2. Development Finance and other State-Owned Financial Institutions Reform. The aim of this reform area is to support the other major elements of the government's SOFI reform program. The results-based component will include (i) reforms and development of a strategy in the area of development finance, (ii) implementing the government's strategy for other state-owned banks, and (iii) improving NPL resolution.

**Component 2: Strengthen Institutional Capacity (US$14.4 million)**

This component will finance technical assistance (TA) and investments in critical areas that are needed to support the achievement of the DLIs. The activities supported by the project in the two reform areas is outlined below.

1. Restructuring BPS. This component will primarily co-finance the new core banking system and applications for the bank as well as consulting services needed to support implementation of the bank's new strategy and business plan.
2. Development Finance and other State Owned Financial Institutions Reform. This component will finance consulting services needed to assist the MoF in overseeing SOFIs, implementing the strategy for state-owned banks, and developing the strategies on NPL resolution and development finance.

This component will also finance TA to support the Central Fiduciary Unit (CFU) for performing its functions related to acting as the Project Implementing Unit. Financing will include staffing support for the functions of financial management, procurement and monitoring and evaluation.

## SAFEGUARDS

### A. Project location and salient physical characteristics relevant to the safeguard analysis (if known)

The project will be implemented within existing BPS and MoF offices.

### B. Borrower's Institutional Capacity for Safeguard Policies

The borrower has adequate institutional capacity for safeguard policies.

### C. Environmental and Social Safeguards Specialists on the Team

Nikola Ille, Environmental Safeguards Specialist
Jelena Lukic, Social Safeguards Specialist

### D. Policies that might apply

| Safeguard Policies | Triggered? | Explanation (Optional) |
|---|---|---|
| Environmental Assessment OP/BP 4.01 | TBD | During project preparation, the team will clarify whether there may be a possibility of retrenchment during the restructuring of Banka Postanska. If such a risk should be identified, the team will prepare retrenchment plans and ensure appropriate consultation or other appropriate mechanisms as part of the preparation and implementation of the restructuring of the bank. |
| Natural Habitats OP/BP 4.04 | No | |
| Forests OP/BP 4.36 | No | |
| Pest Management OP 4.09 | No | |
| Physical Cultural Resources OP/BP 4.11 | No | |
| Indigenous Peoples OP/BP 4.10 | No | |
| Involuntary Resettlement OP/BP 4.12 | No | |
| Safety of Dams OP/BP 4.37 | No | |
| Projects on International Waterways OP/BP 7.50 | No | |
| Projects in Disputed Areas OP/BP 7.60 | No | |

### E. Safeguard Preparation Plan

Tentative target date for preparing the Appraisal Stage PID/ISDS

Feb 01, 2018

Time frame for launching and completing the safeguard-related studies that may be needed. The specific studies and their timing should be specified in the Appraisal Stage PID/ISDS

No safeguard-related studies are planned.

## CONTACT POINT

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### Implementing Agencies

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## APPROVAL

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|---|---|
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### Approved By

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| Practice Manager/Manager: | Mario Guadamillas | 10-Jan-2018 |
| Country Director: | Lada Strelkova | 11-Jan-2018 |