FINANCIAL SECTOR ASSESSMENT PROGRAM UPDATE

SERBIA

TECHNICAL NOTE

CRISIS MANAGEMENT FRAMEWORK

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THE WORLD BANK
FINANCIAL AND PRIVATE SECTOR DEVELOPMENT
VICE PRESIDENCY
EUROPE & CENTRAL ASIA REGION VICE PRESIDENCY
GLOSSARY

CAR capital adequacy ratio
DIA Deposit Insurance Agency
FSSP Financial Sector Support Program
FX foreign exchange
GoS Government of Serbia
IMF International Monetary Fund
LoLR lender of last resort
MoF Ministry of Finance
MOU memorandum of understanding
NBS National Bank of Serbia
SRD Serbian dinar
I. BACKGROUND

1. In light of the outflow of deposits in Serbia in late 2008 and early 2009, a series of measures were introduced to urgently address stability concerns. These measures included increased deposit insurance coverage, shortened payout periods, introduction of regulations on lenders of last report (LoLR) and new liquidity lines, and the possibility for the Deposit Insurance Agency (DIA) to purchase shares of insolvent banks under instruction from the Government of Serbia (GoS). At the time, it was understood that, once stability returned, it would be prudent to have a crisis management framework in place to address systemic financial crises at all times, much like some countries have a framework to deal with natural disasters. The new framework would seek to minimize the need for ad hoc measures during crises and limit the need for the authorities to take measures that are technically illegal. Because of the lack of such crisis provisions, in several past crises, ministers and governors were forced by deteriorating events to take measures for which they had no authority, leaving the passage of appropriate regulation or laws to the aftermath of the crisis. This technical note has been prepared in the context of the initiative, primarily spearheaded by the National Bank of Serbia (NBS), to develop a contingency management framework. In particular, the note discusses the key elements of such a framework, explores how the NBS and other countries are tackling such contingency planning, and suggests ways that the framework proposed by the Serbian authorities can be improved.

II. KEY ELEMENTS OF A CRISIS MANAGEMENT FRAMEWORK

2. An effective crisis management framework should include a clear decision-making process and a definition of responsibilities for the various institutions involved in crisis resolution. The objectives of any crisis management framework are to halt the crisis that is about to unfold or is already unfolding, and to minimize its impact. Hence, speed is of the essence. To ensure that the objectives are met, a clear process for decision making ought to be identified, including an unequivocal identification of the decision-making authorities (and of their alternate), of the principal information upon which decisions will be made, and information sources. The entities involved in the framework vary depending on the local set up, but should involve the central bank, supervisory entities, the institution in charge of bank resolution, the deposit insurance agency, and the ministry of finance. Moreover, if foreign banks are important players in the country, home supervisors might also be involved in the framework. The decision-making process and definition of responsibilities among the various entities are usually enshrined in laws and memoranda of understanding (MoUs).

3. A comprehensive framework includes a menu of measures to enhance market confidence and the provision of liquidity, strengthen the balance sheets of undercapitalized banks, and facilitate loan restructuring. Measures to enhance market confidence include primarily deposit and liability guarantees with various degrees of coverage. Liquidity measures include enhanced LoLR facilities, establishment of foreign exchange (FX) swap facilities, and relaxation of mandatory reserves. Balance

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1 This Technical Note was prepared by Ms. Aurora Ferrari, the World Bank.
Sheet strengthening measures include diagnostic tools and resolution arrangements, including an adequate framework, human resources to implement such framework, and resources to fund resolution. Finally, the framework should facilitate restructuring of the banks’ loan portfolios by giving incentives to the banks to do so and by giving breathing space to banks’ borrowers to repay.

4. These measures need to be designed in a way that provides flexibility of implementation, credibility, sustainability, and an exit strategy. The exact mix of measures required and the extent to which each measure will be required is not known until each crisis hits. Hence in designing a crisis framework, the authorities should give themselves the maximum latitude of operation. Crisis management frameworks aim at stopping the panic among the population, market participants, and investors. Thus the measures adopted under such a framework need to be credible (see Box 1). Since crisis resolution often requires substantial public financial resources, measures under the framework need to take into account the fiscal capacity of the country—an important factor in the framework’s credibility. Finally, in addition to being expensive, measures introduced in crisis management framework can distort market dynamics in normal times: for example, through moral hazard. Hence any crisis management framework needs to include a clear exit strategy (see Box 1).

<table>
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<tr>
<th>Box 1. Credibility and Exit from Blanket Guarantees</th>
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<td>Many countries have announced measures to lessen the impact of the current financial crisis. Most programs include the introduction of blanket guarantees with various degree of coverage of deposits and other liabilities.</td>
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<td>Blanket guarantees have played a crucial role in containing several past crises; some forms of guarantee were introduced in the financial sector crises that unfolded in the 1990s in Finland, Indonesia, Japan, the Republic of Korea, Sweden, and Turkey. The success of blanket guarantees hinges on the credibility of the authorities’ commitment to take action to avert a financial meltdown, and their capacity to finance their commitments. In some countries, a simple policy announcement can carry such credibility; in others, a policy announcement needs to be followed swiftly by a legal commitment. In all the countries listed above, political announcements were immediately formalized in a law—except for Turkey, in which the policy announcement was translated into law only years later.</td>
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<td>While guarantees give governments time to develop suitable policy responses, are easy to implement, and have no upfront fiscal costs, they create potentially large fiscal contingent liabilities and can lead to moral hazard over time. To address this issue, a number of countries that have introduced guarantees on liabilities in the context of the current crisis have also included sunset clauses. These include Australia (three years); Denmark (two years); Greece (initially blanket, then up to €100,000 for three years); Hong Kong (until 2010); Ireland (Sept. 2010); Malaysia (Dec. 2010); Mongolia (five years); New Zealand (two years); Singapore (Dec. 2010); and United Arab Emirates (three years).</td>
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III. THE SERBIAN CRISIS MANAGEMENT FRAMEWORK

5. In response to the deposit outflow of October 2008, GoS enhanced market confidence by increasing deposit insurance coverage and shortening the payout period. By amending the Law on Deposit insurance and the Law on Deposit Insurance
Agency, GoS: (i) increased the deposit insurance coverage from €3,000 to €50,000 per depositor per bank; (ii) expanded coverage to include small and medium legal entities and sole entrepreneurs; and (iii) shortened the period by which the DIA must start paying insured depositors from thirty days to three days.

6. Subsequently, and in conjunction with the program supported by the International Monetary Fund (IMF), GoS launched a financial sector support program (FSSP). The program is voluntary and open to all banks (see Box 2). The program is supported by commitment letters (to maintain exposures in Serbia and adequate levels of capitalization) signed by participating banks. A memorandum of understanding between the Ministry of Finance (MoF), NBS, and DIA regulating information sharing and coordination in times of crisis has been signed under the IMF program. A confidential Annex has been appended to the MoU to identify a roadmap for bank resolution and the key elements of a LoLR facility. To implement the Annex, NBS issued a number of regulations introducing detailed arrangements for a LoLR facility and additional facilities for liquidity provision, and provided incentives for loan restructuring. The discussion that follows presents details of the measures introduced under the FSSP in each of the four pillars (market confidence, liquidity enhancement, balance sheet strengthening, and loan restructuring).

7. Measures adopted to enhance liquidity provision include regulations on LoLR and new liquidity lines. The LoLR facility can be extended at 150 percent of the policy rate to solvent banks against eligible liquid collateral, and has a maturity of up to one year. All banks operating in Serbia are eligible (as opposed to only those participating in the FSSP). Recognizing the tighter liquidity conditions in times of crisis, NBS also introduced two new liquidity facilities for banks that participate in the FSSP: (i) an extended dinar liquidity facility to help banks with loan restructuring; and (ii) a foreign exchange swap facility with a two-week maturity and an implicit rollover guarantee. Further details on these measures and recommendations on the same are provided in the Liquidity Technical Note.

8. Measures to strengthen the balance sheet of undercapitalized banks under the FSSP include a diagnostic tool and a resolution roadmap. NBS has developed a two-phase stress testing methodology. In the first phase, the NBS undertakes on-site inspections focusing on the performance of the loan portfolio. In the second phase, NBS performs stress testing based on a downside scenario on the adjusted bank statements. The resolution roadmap included in the MoU Annex divides banks in three categories based on the diagnostic results: banks that can prove they can raise private funding to increase their capital adequacy ratio (CAR) to 12 percent (type 1); banks that can apply for capital injection from the state (type 2); and banks that will be liquidated (type 3). Banks that qualify to receive a capital injection from the state are systemic banks, defined as banks with a market share of more than 2 percent of total assets of the system and 1 percent of retail deposits of the system. Based on this definition, there are 19 systemic banks in Serbia out of 34. Non-systemic banks that are deemed viable by the NBS can also benefit from public recapitalization, but only up to 50 percent of the capital required.
9. **To promote loan restructuring, loan loss provisioning has been relaxed for restructured loans.** Banks that participate in the FSSP can restructure their loans by stretching the remaining loan maturity by at least 12 months or reducing monthly payments by 20 percent. For such loans, lower loan loss provisioning is permitted.

10. **To deal with financial crises in the future, a Law on Banking Sector Stability has been drafted.** The main purpose of the law is to provide an ex ante framework for coping with future financial catastrophes. Consequently, the law would be similar to emergency laws in place in many countries to deal with natural disasters like earthquakes or flooding, or national security threats. The law provides a framework that will allow GoS to respond quickly with a range of predetermined tools and without further parliamentary approval once certain triggers are activated. Parliamentary approval on the basis of urgent procedure is required, however, when budget resources are needed.

11. **While the Law on Banking Sector Stability will be enacted permanently, the measures listed in the law can be implemented only when a crisis has been declared**

   Based on the law, GoS (upon NBS proposal) can declare a systemic crisis, subject to prior opinion of MoF and DIA. Under such circumstances, deposits and liabilities guarantees with varying degree of coverage can be extended. The cost test for bank resolution can be waived. Funding for financial assistance is to be authorized by an extraordinary session of the parliament. GoS equity, acquired as a result of providing financial assistance to troubled banks, is preceded by write-down of existing shareholders.

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**Box 2. Key Elements of the Financial Sector Support Program**

Twenty-seven banks operating in Serbia (out of 34) have signed up for the program, which involves a mix of commitments and incentives. The program expires at the end of 2010 and requires banks to: (i) obtain specific commitments from parent bank groups to keep their exposure vis-à-vis Serbia at end-2008 levels throughout 2009–10, subject to a review at end-2009 (this applies only to foreign subsidiaries); (ii) keep sufficient level of capitalization and liquidity; and (iii) participate in a stress test exercise based on IMF methodology and a downside scenario. The NBS completed the diagnostic studies for all banks in December 2009. Subsidiaries and local banks participating in the program have been asked to facilitate voluntary conversion of FX and FX-linked loans into local currency loans, and work with the NBS toward developing a common loan workout scheme that would avoid unnecessary blockage of delinquent but solvent borrowers’ accounts. They are also encouraged to facilitate loan restructuring under a pre-agreed framework, which requires the remaining loan maturity to be extended by at least 12 months or the monthly payments to be reduced by at least 20 percent.

In terms of incentives, the participating banks have been granted access to two new liquidity facilities: (i) an extended dinar liquidity facility, and (ii) a foreign exchange swap facility. The first aims to help banks with loan restructuring and will involve provision of dinar loans with maturities of up to a year, against a broad range of collateral and with a non-penalty interest rate. The FX swap facility offers each bank a swap line out of a designated pool of funds of up to €1 billion. Swaps are offered with a two-week maturity and an implicit rollover guarantee. The NBS has amended regulations related to risk management to facilitate fulfillment of the commitments. In particular, the NBS has raised the limit on subordinated debt-to-Tier I capital ratio from 50 to 75 percent and the net open FX position from 10 to 20 percent of capital.
rights and needs to be divested within a year. To enhance LoLR facilities available in normal times (Reg. 96/2008), NBS can request that GoS issue a guarantee to solvent banks with insufficient eligible collateral or to significantly undercapitalized systemic banks. MoF guarantee would be given against bank collateral that includes mortgages (up to 70 percent of book or market value—whichever is lower), receivables (up to 60 percent of book value), and acceptable securities. During a systemic crisis, GoS is required to report to the parliament once per month on measures undertaken. A systemic crisis situation is revoked by GoS upon the suggestion of NBS or DIA.

IV. RECOMMENDATIONS FOR THE CRISIS MANAGEMENT FRAMEWORK

12. The legal provisions included in the Law on Banking Sector Stability are generally sound. The proposed legal provisions include three of four pillars of a comprehensive framework (namely enhancement of market confidence, liquidity provision, and strengthening the balance sheets of undercapitalized banks). The provisions also provide for enough latitude of implementation (all measures can be triggered in various degrees) and include an exit strategy. Other benefits that would accrue from the approval of the provisions include: (i) capacity to use crisis tools without further parliamentary approval; (ii) improved credibility of adopted measures; and (iii) enhanced coordination and cooperation between GoS and NBS by requiring them to work together to declare and resolve a systemic crisis. The only downside derived from the approval of such provisions is that, if not well explained, they could trigger market and public anxiety.

13. Other countries have included similar systemic crisis provisions in their legal frameworks. Some countries have included such provisions in the existing legal framework, such as the Federal Deposit Insurance Act in the United States. Others have included, or are in process of including, provisions in so-called crisis laws, such as Lithuania, the Dominican Republic, and Brazil (the latter is still drafting such a law). Systemic crisis provisions are applicable only in times of crisis and allow for state funding for recapitalization of banks (Lithuania), waiving the least-cost test for bank resolutions in certain circumstances (the United States), and for different levels of guarantees on deposits or other liabilities (Brazil, Lithuania, the United States). A determination is made as to whether a crisis situation exists by some combination of the MoF and is initiated in consultation with the central bank, and deposit insurance agency.

14. Whether the proposed legal provisions should be included in one law or be introduced by amending a number of laws is a matter of legal drafting and other local circumstances. The provisions included in the Law on Banking Sector Stability could be approved as a stand-alone law (Lithuania) or as amendments to different laws to

2 That is, it avoids the necessity of the public announcement of policy followed by the uncertainty of parliamentary action. It should be noted that it took Serbia’s parliament three months to enact an increase in deposit insurance in late 2008.
which these provisions create exceptions applicable in times of crisis (the United States). Various countries have followed different routes, and such decisions really rest on the legal drafting tradition of each country. However, the inclusion of a complete framework in a single law makes the framework particularly transparent.

15. In addition to approving the proposed legal provisions, the high deposit coverage introduced in the wake of the deposit outflow should be decreased gradually. The deposit insurance coverage was introduced as an *extrema ratio* to stem the deposit outflow in October 2008. However, the credibility of the measure has been questioned. (The DIA has enough resources to cover the deposits of any of the twenty smallest banks individually, or the sum of the smallest nine, and has no emergency funding arrangements.) In the long run, it might encourage market participants to take excessive risk (under the new limit, 99 percent of the deposits in number and 90 percent in volume are covered). A carefully calibrated policy mix is required to address these shortcomings: (i) approval of legal provisions that allow for varying degree of deposit and liability guarantees; (ii) plan for implementing a reduction of coverage level along with a carefully managed public information campaign; and (iii) establishment of an emergency funding arrangement for the DIA should, for example, a medium/large bank be liquidated. In addition, steps should be taken to ensure that DIA has the operational capacity to fulfill other measures introduced in the wake of the October 2008 deposit run, such as to speed up deposit repayments. More detailed recommendations are included in the Deposit Insurance Technical Note.

A. Proposed Minor Amendments

16. While the proposed crisis framework, including the Law on Banking Sector Stability, is adequate, some minor amendments are recommended. These include: (i) rapid approval of GoS guarantees for LoLR and flexibility in determining collateral and haircuts for LoLR; (ii) removal of the resolution roadmap component, which makes almost all undercapitalized banks eligible for recapitalization with GoS funding; (iii) adoption of legal amendments that allow institutions other than banks to hold loans on their balance sheets; and (iv) development of MoUs, implementing procedures, and other institutional arrangements on crisis management with the home jurisdictions of the largest investors in the country, since many banks in Serbia are foreign. Finally, to implement the legal provisions and identify a systemic crisis, NBS should develop a systemic risk assessment framework, which should be agreed with the MoF and DIA. More detailed recommendations on each are provided below.

17. Enhanced LoLR measures should include provision to obtain GoS guarantees rapidly, and respective collateral and haircuts should not be prescribed in the law. A provision to obtain GoS guarantee for banks without adequate eligible collateral under urgent parliamentary procedure should be included in the draft Law on Banking Sector Stability. Moreover, no list of adequate collateral or allowed level of haircuts for GoS guarantee should be included in the law, as these might need to be changed over time. It is also advisable to restrict the list of collateral allowed for LoLR in normal times (defined in NBS regulation) and to expand the list for crisis times.
18. The resolution mapping included will need updating in light of the new resolution tools available and potential blanket guarantee available during crises. The proposed amendments to the Banking and Deposit Insurance Laws should introduce new bank resolution tools (applicable in both normal and crisis times) and include a comprehensive definition of financial assistance. The amendments include all required tools, except for guarantees on debt issue for banks that are not in receivership, as financial assistance can be provided only to intervened banks. The objective of the resolution mapping included in the Annex to the crisis MoU is to promote stability by protecting all liabilities in the largest banks. Due to the introduction of proposed resolution tools and the draft Law on Banking Sector Stability, the same objective can be achieved in a less costly fashion. Hence, the Annex needs to be amended to be brought in line with the new resolution and crisis framework. Finally, the Annex could include broad principles that banks receiving public funding need to follow while in state majority or minority ownership.

19. To incentivize banks to restructure loans, the blocked account system needs to be restructured and the legal impediments to a secondary loan market need to be removed. NBS regulations aimed at promoting loan restructuring on an individual bank basis can have limited impact due to the blocked account system, which de facto requires a multiparty workout process. Recommendations on how to improve the systems are presented in the Corporate Debt Restructuring Technical Note. Moreover, only banks are allowed to make and hold/own loans. As a result no secondary market for loans exists (see Bank Resolution Technical Note). Consequently, measures to incentivize banks to clean up their loan books cannot have much impact.

20. It is recommended that crisis management MoUs be urgently developed and other steps taken to ensure adequate cooperation with the most important home supervisors. In light of the importance of foreign banks in the Serbian market, it is paramount that the authorities develop MoUs on crisis management with the home jurisdictions of the largest investors in the country. The urgency of the recommendation is heightened by the fact that no MoUs for noncrisis situations have been developed with these authorities. As a result, the Serbian and relevant home authority do not have a basis of cooperation from which to start, as a crisis management framework works best if built on cooperation in normal times. Steps should be taken to ensure that MoUs on crisis management will actually function in times of need. Key features of successful MoU on crisis management are presented in Box 3.
Finally, to implement the provisions included in the Law on Banking Sector Stability, and identify systemic crisis, NBS should develop a systemic risk assessment framework. Without a well-established analytical framework, it will be very difficult to meet the challenges posed by financial crises: namely, acute time pressure and incomplete information. It is therefore recommended that the authorities define in advance the criteria on which basis institutions can be identified as systemic and therefore may be eligible for public funding. Relevant considerations typically include the functions that the affected financial institution fulfills, its main users, size, substitutability (the ease with which its functions can be taken over by other institutions), and the main linkages with other parts of the financial system and the real economy. Criteria to establish whether the affected part is truly systemic should be agreed in advance, whereas thresholds may be changeable depending on circumstances at the time. Besides identifying such criteria, specific staff need to be given the responsibility to conduct systemic risk assessments in times of crises. Information needs should be identified and procedures put in place to ensure that key information that is needed is either readily available or can be made available at short notice.

Box 3. MoU on Crisis Management among the Nordic countries

The MoU among the Nordic countries on management of financial crisis in banks with cross-border establishments is considered a best practice example. Key elements of this MoU include:

1. Regular and formalized exchange of information and cooperation between home and host supervisors. The MoU on crisis management is effective, as there is cooperation on paper and in practice in normal times. Trust and communication channels are crucial to ensure speedy action in times of crisis. Only by maintaining regular cooperation in normal times and cultivating familiarity among the supervisors there can be effective cooperation in time of crisis.

2. Clear division of responsibilities between host and home supervisors and among home and host country entities involved in crisis management (such as the Ministry of Finance, central bank, deposit insurance funds, and resolution agencies). Key issues on which a division of responsibility is spelled out include: who will take the lead on liquidity provision, on determination of bank solvency, and on bank intervention (that is, should a temporary administrator be introduced or should staff from the parent bank take over the bank?)


Source: Management of a Financial Crisis in Banks with Cross border Establishments – Memorandum of Understanding between the Central Banks of Denmark, Finland, Iceland, Norway and Sweden

21. Finally, to implement the provisions included in the Law on Banking Sector Stability, and identify systemic crisis, NBS should develop a systemic risk assessment framework. Without a well-established analytical framework, it will be very difficult to meet the challenges posed by financial crises: namely, acute time pressure and incomplete information. It is therefore recommended that the authorities define in advance the criteria on which basis institutions can be identified as systemic and therefore may be eligible for public funding. Relevant considerations typically include the functions that the affected financial institution fulfills, its main users, size, substitutability (the ease with which its functions can be taken over by other institutions), and the main linkages with other parts of the financial system and the real economy. Criteria to establish whether the affected part is truly systemic should be agreed in advance, whereas thresholds may be changeable depending on circumstances at the time. Besides identifying such criteria, specific staff need to be given the responsibility to conduct systemic risk assessments in times of crises. Information needs should be identified and procedures put in place to ensure that key information that is needed is either readily available or can be made available at short notice.

3 This includes capital injections with public money and the issuance of guarantees. It may also include emergency liquidity assistance.