REPUBLIC OF SERBIA

TECHNICAL NOTE

CAPITAL MARKET DEVELOPMENT

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GLOSSARY

ANNA	Association of National Numbering Agencies
ASB	Association of Serbian Banks
BELEX	Belgrade Stock Exchange
BEONIA	Belgrade OverNight Index Average
CSD	Central Securities Depository and Clearing House
DvD	Delivery versus Delivery
DvP	Delivery versus Payment
EBRD	European Bank for Reconstruction and Development
EUR	Euro
FoP	Free of Payment
FV	Fair Values
GBI	Government Bond Index
GDP	Gross Domestic Product
GFC	Global Financial Crisis
ICSD	International Central Securities Depository
IFRS	International Financial Reporting Standards
IOSCO	International Organization of Securities Commissions
IRS	Interest Rate Swap
MiFID	Markets in Financial Instruments Directive
MoF	Ministry of Finance
MoE	Ministry of Economy
MoLEVSA	Ministry of Labor, Employment, Veteran and Social Affairs
MTP	Multilateral Trading Platform
NAV	Net Asset Values
NBS	National Bank of Serbia
OMO	Open Market Operation
OTC	Over the Counter
RSD	Serbian dinar

RTGS	Real Time Gross Settlement System
SOE	State Owned Enterprise
SSC	Serbia Securities Commission
UNCITRAL	United Nations Commission on International Trade Law
USD	USA dollar
VPF	Voluntary Pension Fund

FOREWORD

This Technical Note was prepared by Zsolt Bango (Senior Financial Sector Specialist, World Bank), Sonia Marie Cattarinussi Iacovella (Senior Financial Sector Specialist, World Bank) and Eddy Rodriguez (World Bank Consultant) in the context of the Serbian Capital Market Assessment mission in Belgrade during June 2018 led by Zsolt Bango. The primary objective of the mission was to conduct a diagnostic of the Serbian capital market, with a view to make recommendations for capital market development. The note contains technical analysis and detailed information underpinning the assessment's findings and recommendations. The report was written under the guidance of Gunhild Berg (Senior Financial Sector Specialist, World Bank) and Johanna Jaeger (Senior Financial Sector Specialist, World Bank) and the team received excellent support from Tanya Konidaris (Senior Financial Sector Specialist, World Bank).

The team is grateful to Linda Van Gelder (World Bank Regional Director for the Western Balkans), Stephen Ndegwa (World Bank Country Manager for Serbia), Mario Guadamillas (World Bank Practice Manager for Finance, Competitiveness and Innovation), Marco Hernandez (Program Leader for the Western Balkans – Equitable Growth, Finance and Institutions) and the Western Balkans Country Management Team for their guidance and support throughout this task.

The World Bank team wishes to thank the authorities, particularly the Ministry of Finance and Serbia Securities Commission, as well as the Belgrade Stock Exchange, the Central Securities Depository and Clearing House, and the National Bank of Serbia for their kind hospitality and logistical support for the mission and the inputs received.

EXECUTIVE SUMMARY

Capital markets in Serbia are shallow and relatively underdeveloped. The only market segment that functions comparatively well is the government bond market. The contribution of capital markets to financing the economy is limited. The private sector is not making use of non-government bond markets for its financing needs, given easy access to affordable bank loans in Serbia's bank-dominated financial system. Until recently there was no IPO activity since 1940, symptomatic of Serbia's shallow public and private equity markets. The institutional investor base is thin; the aggregate size of mutual funds and voluntary pension funds is less than 1.5 percent of GDP.

An analysis of the preconditions that support capital market development suggests that not all preconditions are in place in Serbia. The macro fundamental prerequisites are in place and do not hinder capital market development. These include: macroeconomic and political stability, and an overall strong legal and regulatory framework (including corporate law, insolvency law and the overall tax framework). However, other preconditions are missing, particularly with respect to the demand for and supply of capital markets instruments. The corporate markets suffer from both demand and supply challenges, but the biggest constraint for corporate market development is the lack of supply, notably the lack of companies suitable and willing to issue securities. A surplus of liquidity and competitive bank funding means that companies do not need to access the capital markets. In addition, the investor base is shallow. While this report recommends some technical interventions for corporate markets, without these preconditions in place, development will be unlikely in the short and medium term. These preconditions will need to be addressed for non-government capital markets development to be feasible. Finding ways to grow and finance companies and develop the corporate sector as well as the investor base will be important. In the near term, the focus for capital market development should be on improving the operation of the money market and the government bond market. Please see Annex 1 for the framework for analysis of the preconditions and capital markets. This report broadly follows the framework while adapting to the country context.

Liquid and more developed money markets would support broader capital market development. A **s**tructural liquidity surplus in the domestic banking system has led to relatively low activity in the interbank money market. Interbank lending is mostly related to overnight uncollateralized transactions. Major tools that commercial banks use to manage their daily liquidity are the one-week reverse repo and the standing facilities (deposit and lending) offered by the central bank. Although repo facilities exist, they are not used as market participants experienced until recently a lack of certainty in the ring-fencing of collateral against the repo trade in the event of insolvency, i.e. close out netting was not in place. This has been addressed in the new Law on Financial Collateral, which is expected to boost repo market liquidity. In the absence of active interbank trading, short term rates of the yield curve are considered unreliable by market participants. More reliable short-term rates would facilitate the development of new derivative instruments, providing hedging instruments for investors, and would provide pricing reference for the private sector, allowing for more reliable and accurate pricing of credit instruments.

The government bond market has made substantial progress in recent years. The Public Debt Administration (PDA) has successfully launched the benchmark building program, which helps with the consolidation of the domestic government bond portfolio and supports the liquidity of the secondary market. The bond market has a solid foundation with the necessary infrastructure and a benchmark yield curve set by the regular issuance of RSD-denominated government securities. Nevertheless, secondary markets require further development to contribute better to price discovery and strengthening of the yield curve. More predictable and consistent primary market operations, improving transparency of the secondary market, and regular calculation and publication of the yield curve can enhance liquidity and attract wider investor participation. The increasing refinancing risk caused by the USD 1 billion equivalent benchmark sizes should be addressed with the implementation of regular liability management operations so that the Ministry of Finance (MoF) can mitigate the volatility of the Treasury Single Account. Given the fact that the first large benchmark bond maturity is due in early 2019, a buyback operation had to be introduced. The PDA successfully conducted the first two buyback auctions in November and December 2018.

As opposed to the government bond market, the non-government bond markets remain nascent and shallow. The corporate bond market is effectively non-existent; there have been no public issuances for years, while the size of the scattered private placements is mostly small. The private sector relies largely on commercial bank financing instead of the corporate bond market since it is cheaper, faster and easier to understand. A review of the current taxation framework as well as the cost and fee structure of private placements and public issuances of corporate bonds is necessary to incentivize private sector participation in the non-government bond market.

Adverse tax regulations negatively impact the non-government bond market, discouraging both domestic and foreign investors from investing in these products. While returns on government bond investments are tax exempt, there is no tax relief for investments in other capital market products—i.e. investments in corporate bonds and equities are subject to tax. Complicated administrative procedures (such as a mandatory local tax representative for non-residents) and adverse tax rules on interest rate swaps (receiver leg is fully taxed instead of the net amount between the payer and receiver legs) contribute to reduced investor demand on the non-government-bond markets. The elimination of cumbersome tax arrangements is necessary to mobilize domestic savings more efficiently and to attract foreign investors.

The development of the equity market seemed promising prior to the financial crisis, but the market structure changed substantially since then and trading volumes have declined dramatically. Because of mass privatization before the Global Financial Crisis (GFC), more than 4,000 new companies were listed on the stock exchange, attracting foreign investors and domestic mutual funds. However, the stock market collapsed in 2008 during the GFC causing considerable losses to investors, who consequently lost their confidence in the equity market. Rebuilding investor confidence is challenging, especially if the stock market does not offer attractive investment alternatives. There are hardly any valuable companies with substantial free-floats listed on the stock exchange and the daily turnover is negligible. Although the stock exchange has had several initiatives and infrastructural upgrades to attract prospective companies to use capital markets for their financing, until recently there was no IPO in Serbia since 1940. Fintel Energija successfully completed Serbia's first IPO at the end of October 2018. With the support of EBRD and PwC, BELEX launched the IPO Go! Project in 2018, which is expected to bring at least one more IPO through the stock exchange in 2019. Nevertheless, these activities will not eliminate the challenges BELEX is facing and more actions are necessary to demonstrate the need for the local stock exchange.

Expanding and diversifying the investor base could help strengthen capital markets, particularly the corporate bond and equity markets. The investment fund industry is very small. Even though the first mutual funds were set up more than ten years ago, the volume of savings invested in these funds accounts for less than 1 percent of GDP. Savings collected by Voluntary Pension Funds (VPFs) have been growing continuously, however the aggregate size of the industry is just slightly higher than that of the investment funds. The insurance sector is more developed, but significantly lags behind the EU average.

Financial education of the population is necessary to help mobilize savings for long term finance. The awareness of the general population of savings schemes other than commercial bank deposits is low. Individuals prefer cash or commercial bank deposits and tend to keep their savings in foreign currency despite the relative stability of the RSD against the EUR in recent years. People still have vivid memories of the heavy RSD depreciations in the past 20-25 years, which, at that time, severely affected their confidence in the local currency.

Financial service providers operate under a regulatory framework that is proportionate to the current development stage of the Serbian capital markets. The Serbian capital market is regulated and supervised by the Serbia Securities Commission (SSC), an autonomous and independent organization of the Republic of Serbia, together with the Ministry of Finance which is in charge of legal policy-making for financial services. The SSC has adopted a global regulatory environment which tends to be similar in structure to that of a developed market place, notably the EU. The regulatory framework is set to promote transparency and protect shareholders' and investors' interest. Investment firms, funds and their managers are subject to operational and business conduct rules, and regular reporting and supervision by the authorities. Regulated market operators must be headquartered in Serbia, and their operations require an approval license by the SSC, including on the exchange's rules and procedures, access to systems and information, listing rules, market surveillance and disciplinary procedures, and dispute resolution procedures.

Serbia's EU accession negotiations will lead to changes in the legal and regulatory framework related to capital markets. While new legislation and regulation should align with the fundamental direction and principles of the EU directives, only sections appropriate for the level of market development should be included to provide additional guidance to the market where necessary and to not impose unnecessary costs. A gradual and proportionate implementation should be pursued. It will be important that the involved authorities (MoF, SSC, National Ban of Serbia, Central Securities Depository as well as BELEX and the Deposit Insurance Agency) are able to mobilize their staff to implement these changes. Market players must be aware of the changing legal and regulatory framework.

The SSC should focus on further implementing a risk-based supervisory framework. Given the growing pressure on resources, the SSC is encouraged to focus on supervising the major sources of risk and to accordingly continue developing a reporting framework, risk indicators, its off-site surveillance process, and to use on-site inspections in a more strategic manner.

KEY RECOMMENDATIONS

Table 1. Key Recommendations from the Serbia Capital Market Assessment 2018

Recommendation	Responsible agency	Time
Capital market strategy		
Prepare a capital market development strategy and action plan with a focus on: • Supervisory and exchange measures to improve confidence in the capital markets; • A strategy on growing and attracting issuers; • A roadmap to comply with EU objectives; and • Ways to grow the investor base.	MoF, SSC, NBS, BELEX	I
Demand (investor base) and supply		
Conduct diagnostics for pension and insurance market development	NBS, MoF	I
Consider increasing investment funds' investment limits in Serbian government securities	MoF, SSC	NT
Improve public awareness of VPFs	MoF, MoLEVSA, NBS	NT
Review tax procedures for foreign investors	MoF, SSC	NT
Identify ways to grow and develop the corporate sector	MoE, MoF	C
Money markets		
Assess repo market development after the implementation of the Law on Financial Collateral	NBS	NT
Review BELIBOR rules; request firm quotes from panel banks	ASB, ACI Serbia	I
Support development of FX derivatives with the development of reliable short-term reference rates	MoF, NBS	MT
Government securities market		
Improve the predictability of the primary market operation; adhere to the auction calendar	PDA	NT
Calculate and publish official yield curve daily	PDA	I
Separate secondary market trades from the settlement of primary auction deals	PDA	I
Introduce regular liability management operations (buyback and/or switch)	PDA	I
Non-government securities market		
Provide the same tax treatment for non-government securities as for government securities	MoF	NT
Simplify tax procedures; reduce administrative burdens	MoF	NT
Assess options for facilitating and supporting IPOs of private sector corporates	BELEX, MoF, SSC	MT
Improve financial literacy of individuals and capital market awareness of corporates	BELEX, MoF, SSC	MT
Consider strategy to resolve dormant accounts	CSD, MoF, SSC	MT
Derivative markets		
Amend tax regulation of IRS transactions	MoF	NT

Regulatory and supervisory framework		
Continue implementing a risk-based supervision and enforcement framework of the market and its actors (including funds), using both off and on site	SSC	I
Adopt a risk-based approach to capital adequacy requirements	SSC	I
Adopt in-depth and risk-based supervisory processes for reviewing issuer financial and non-financial information	SSC	NT
Better inform the public on the recognised collateral management rules (e.g. clarify their scope and how automatic contractual netting arrangements operate under Serbian law)	SSC	I
Request post trade timely reporting of transactions executed on lite and dark market, and OTC	SSC, BELEX	NT
Consider enforcement of sales or purchases of financial instruments to disincentivize failed transactions in the clearing and settlement system	SSC	NT
Consider enhancing the use of credit rating of local companies and credit rating referral for managers	SSC, BELEX	NT
Enhance transparency by expanding on-line availability of, among others, previous regulations, regulatory consultation processes, internal compliance structure of the SSC, availability of ombudsman services, and on-going work by the SSC	SSC	NT

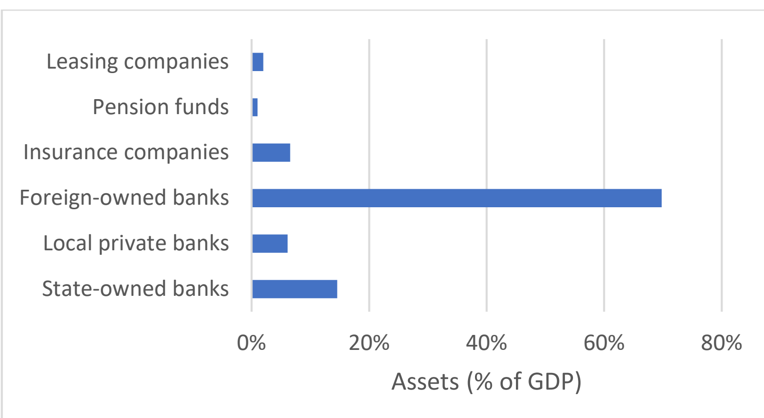
Time Frame: C = continuous; I (immediate) = within one year; NT (near term) = 1-3 years; MT (medium term) = 3-5 years.

I. Macro-Fundamental Preconditions

1. **Capital markets can play a strong role in economic growth, but certain preconditions need to be in place for capital markets development to be possible.** Efficient capital markets can provide financing for the state and the private sector by offering access to domestic and international financial resources. The primary function of capital markets is therefore to facilitate the link between various types of investors (domestic savers including domestic institutional pension funds, insurance companies, commercial banks, and domestic retail and foreign investors) and different issuers (mainly large- and medium-sized real sector companies, the financial sector and governments). Developed capital markets provide a range of investible assets for domestic institutional investors and facilitate the diversification of the investor base and enable issuers to raise funds, often at lower costs, from various non-bank sources. Factors considered when looking to assess whether the macro-fundamental preconditions are in place include: macro-political stability; level of savings; the structure of the corporate sector; the broader legal and regulatory framework (insolvency law, tax law); the level of interest rates; and the soundness of the banking sector.

2. **Serbia's financial sector is bank-dominated with a small institutional investor base.** The banking sector accounts for 90.7 per cent of overall financial sector assets as of end-2017 (Figure 1). Assets of pension funds, insurance companies and investment funds, the domestic institutional investors, account for 0.8 percent, 6.6 percent and 0.6 percent of GDP respectively—together less than 10 percent of financial sector assets.

Figure 1. Structure of the financial sector at the end of 2017



Source: NBS

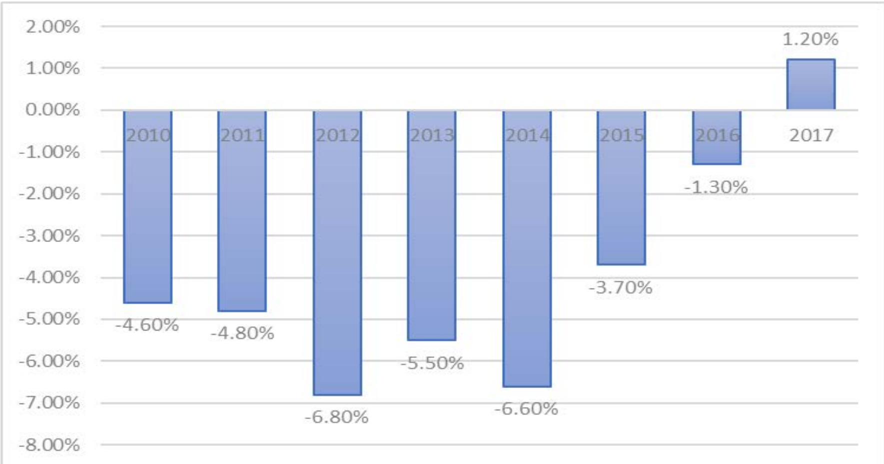
3. **The government securities market is by far the largest segment of the capital markets.** Government securities—RSD and EUR-denominated government securities issued on the domestic market—amount to 38 percent of GDP at the end of 2017. The size and liquidity of non-government bond instruments, however, is negligible. The total volume of outstanding corporate bonds accounts for not more than 0.1 percent of GDP[1]. The capitalization of the equity market is less than 13 percent of GDP. Government bond trading accounts for almost 90 percent of the total turnover and less than 3 percent of the revenues of the Belgrade Stock Exchange (BELEX). Secondary market trading on the equity market decreased significantly after the GFC.

[1] Based on figures at the end-2017.

4. The global financial crisis of 2008 negatively impacted Serbia's capital markets and exposed several weaknesses as well as a lack of market development. Serbia faces considerable challenges on both the demand and supply side for capital markets. Although there have been many initiatives (e.g. tax arrangements, retail instruments, SOE privatization) since the GFC to enhance capital market development, most of the issues have not yet been resolved. The non-government capital markets in particular suffer from a lack of confidence. This is a result of the stock price collapse in 2008 that continues to negatively impact market growth. On the demand side, a sizeable and diversified investor base is lacking, while on the supply side there is an extremely limited issuance pipeline for equities and corporate debt.[2]

5. The macroeconomic environment is currently not hampering capital markets development. Serbia successfully implemented a fiscal consolidation program between 2014 and 2017, which helped restore macroeconomic stability after the GFC. Serbia experienced a large twin-deficit in the first half of this decade. The central budget deficit peaked above 5 percent of GDP, while the current account deficit reached double digit levels. The fiscal balance improved from a 6.2 percent deficit in 2014 to a 1.1 percent surplus at the end of 2017 (Figure 2). The current account balance has declined to around 4 percent, fully covered by FDI inflows. GDP shrank at the beginning of the fiscal consolidation program, however it soon turned up in the third quarter of 2014 and Serbia managed to retain the positive trend since then. In the last two years (2016 and 2017) GDP grew by 3.3 and 2.0 percent respectively. The program helped strengthen Serbia's public debt financing position. The public debt to GDP ratio declined from a peak of 70 percent in 2015 to below the 60 percent Maastricht target by the end of 2017 (57.9 percent at the end of December 2017. The next phase of the program will focus on pending institutional and structural reforms to create an enabling environment for sustainable, dynamic GDP growth.[3]

Figure 2. Consolidated fiscal balance (% of GDP)



Source: MoF

[2] According to the World Economic Forum Global Competitiveness Report, Serbia's "financial market development" was ranked as 79th economy of the 137 surveyed countries in 2017, which was 10 places higher from the level (89) occupied before the crisis in 2007. "Access to financing" was mentioned as the second most problematic factor for doing business in the same report. Source: World Economic Forum: The Global Competitiveness Report 2008-2009, 2017-2018 and 2018.

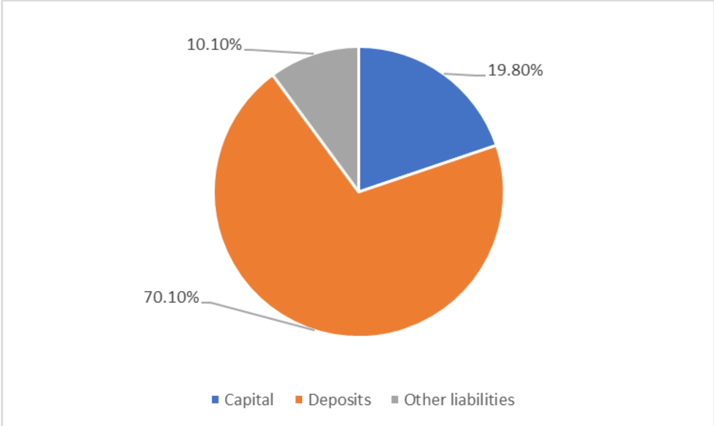
[3] Source: Dusan Vujovic: Serbia beyond fiscal consolidation: a quest for dynamic, sustainable, inclusive growth (December 2017).

6. **The banking system has stabilized since the crisis.** Non-performing loans (NPLs) soared after the crisis. In 2009 alone, as the crisis escalated, the stock of NPLs increased by over 50 percent (from around RSD 131 billion at end-2008 to around RSD 202 billion at end-2009). In the following years the share of NPLs expanded further, exceeding 20 per cent of total gross loans at the peak. With the adoption of the NPL Resolution Strategy in August 2015, the ratio of NPLs declined significantly, falling below 10 percent at the end of 2017 and continuing to decline in 2018 (6.3 percent as of October 2018).[4]

7. **The banking sector in Serbia was highly capitalized and liquid in 2017.** The capital adequacy ratio has been improving continuously in recent years and reached 22.6 percent at the end of 2017. The average monthly liquidity ratio stood at 2, well above the regulatory minimum of 1. The liquidity coverage ratio, at 239.5 percent was also well above the limit set by the regulator. Liquid assets accounted for 35.1 percent of total balance sheet assets and 50.9 percent of short-term liabilities. Commercial banks are the largest buyers of RSD-denominated government securities—their share was 55.4 percent at the end of 2017. In terms of ownership structure of banking sector assets, the largest share was held by foreign-owned banks (77 percent), followed by state-owned banks (16 percent) and domestic private banks (7 percent).[5] Only one domestic bank is listed on the Standard listing segment of the Regulated Market of the BELEX. Shares of one domestic bank are available for trade in the MTP platform and another one in the Open Market segment. None of the foreign banks are listed on the BELEX platforms.

8. **Commercial banks rely mostly on domestic funding.** A continuously growing domestic deposits base helped reduce the loan to deposit ratio from 127 percent at its peak in 2011 to 93.2 percent at the end of 2017. In the overall banking sector, deposits accounted for 70.1 percent of liabilities (Figure 3). The share of FX deposits (mainly EUR) is still high, accounting for 68 percent of the total. As the growing deposit base provides sufficient financing resources, commercial banks' need for capital market funding is currently limited.

Figure 3. Sources of banking sector funding (2017)



Source: NBS

9. **Serbia's credit rating has been improving, however it is still below investment grade level.** FITCH, Moody's and Standard and Poor's upgraded Serbia's credit ratings by one notch with a stable outlook in 2017 (Table 2). In December 2018 S&P revised the rating outlook from stable to positive.

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[4] Source: Jorgovanka Tabakovic: Resolution of nonperforming loans in Serbia: Stability as an imperative.

[5] Source: NBS.

Table 2. Credit rating of Republic of Serbia, as of December 2018

		FITCH ratings	Moody's Investors Service	Standard and Poor's
Rating		BB	Ba3	BB
Outlook		Stable	Stable	Positive

Pending issues

10. **Serbia should consider developing a comprehensive medium to long term capital markets development strategy and action plan.** For corporate markets the focus should be on restoring confidence in the domestic capital markets and attracting issuers, while developing a roadmap to advance compliance with EU directives in parallel. The capital markets development strategy and action plan could support the enhancement and further development of the legal and regulatory framework, regulatory capacity, and market infrastructure. While macro-fundamental conditions are not hampering the growth of these markets, the strategy should consider ways to address other preconditions, particularly growing the supply of candidates for issuance and growing and diversifying the investor base. While many of these actions are not within the authority of the capital market regulatory and supervisory entities, the strategy would be a way to focus the Government's attention on the measures needed and their link to capital markets development. Without first addressing these significant supply and demand side constraints, any technical measures contained in a capital markets development strategy will be unlikely to have much impact in the short and medium term.

II. Initial Demand and Supply Side Assessment

A. Demand – Investor Base

11. **A diversified investor base for capital markets instruments is a key precondition for domestic capital markets development.** A diversified group of investors, including domestic institutions, domestic retail, foreign and bank investors—with varying investment horizons and risk tolerances—is necessary for developing the domestic capital market and extending the government securities yield curve. Promoting greater participation from diverse sets of investors requires equitable treatment and access to the capital markets. Investors with different motivations to purchase securities may increase secondary market transactions as a means to express their views on asset prices and rates and to manage the allocation of assets under management.

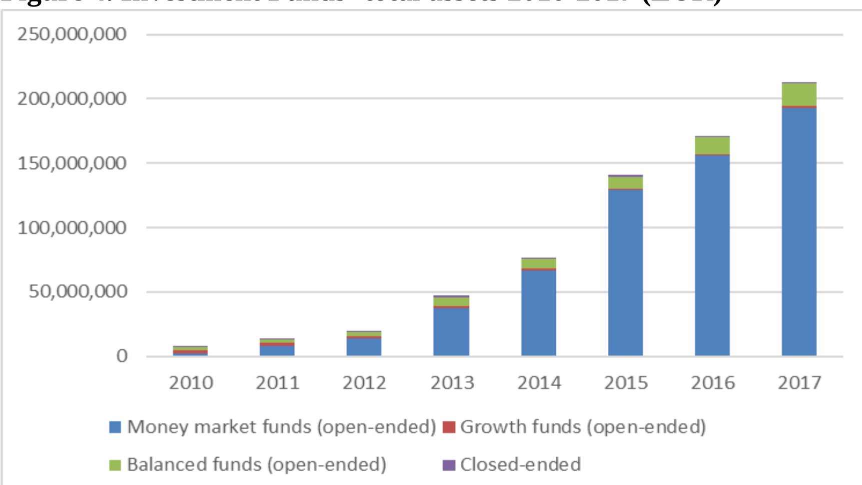
Current arrangements

12. **Serbia's domestic institutional investor base is underdeveloped—the most important demand side constraint for capital markets development.** While the mutual fund and voluntary pension fund industries exist and have been growing continuously, their total size remains negligible. At the end of 2017, the size of assets under management of investment funds amounted to EUR 213.22 million[6], while voluntary pension funds managed RSD 36.32 billion[7] (~EUR 306.9 million) of assets. These figures represent about 0.57 and 0.81 percent of GDP respectively.

[6] Source: SSC.
[7] Source: NBS.

13. The mutual fund industry suffered a significant setback during the GFC and has not managed to recover since. The first investment funds were established in 2007, right after the adoption of the Law on Investment Funds. At the start, the growth of the investment fund industry was rapid. Several funds were set up within a short period of time, however this occurred on the eve of the GFC. Most funds were growth funds, investing a large proportion of their assets in shares listed on the BELEX. Because of the plunge in stock exchange prices, the investment fund industry collapsed. Individual investors' confidence in the fund industry has not yet been restored. After suffering huge losses during the crisis, most of the funds that continued their operation were transformed from growth funds into money market funds. Currently, there are six authorized fund management companies[8] running 19 investment funds. Sixteen funds are open-ended, one closed-ended and two private investment funds. 90.3 percent of the assets belong to money market funds, 8.4 percent to balanced funds and 0.9 percent to growth funds, while the remaining 0.4 percent to the only closed-ended fund (Figure 4).

Figure 4. Investment Funds' total assets 2010-2017 (EUR)

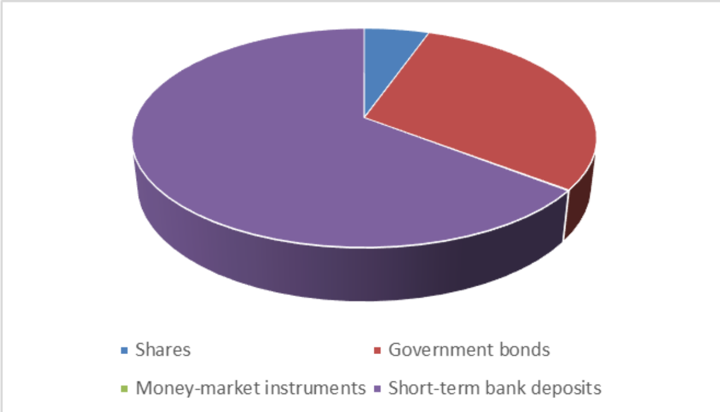


Source: SSC

14. Assets under management are mostly invested in short-term bank deposits due to a legal limit on investments in government bonds. Overall, 64.5 percent of assets are invested in short-term bank deposits, mainly because the share of Serbian government bonds cannot exceed 35 percent in the portfolio based on the Law on Investment Funds (Figure 5). Allowing a higher investment limit for Serbian government bonds could be mutually supportive for government bond market development by increasing demand for the asset, as well as for developing more sophisticated fund management. It could also be a way to encourage investors back into the industry through a high-quality asset. A review of the investment limits for mutual funds should therefore be undertaken, including to allow for a higher investment limit for government bonds.

[8] Five fund managers manage the 19 investment funds, the sixth company has received its license just recently.

Figure 5. Investment allocation of investment funds (December 31, 2017)



Source: SSC

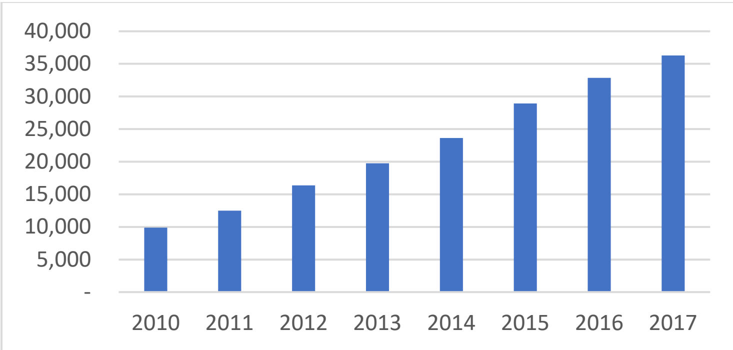
15. The MoF is currently working on the draft Law on Alternative Investment Funds as well as the amendment of the Law on Investment Funds to harmonize it with the relevant EU legislation. Both laws are expected to be approved by the Parliament in 2019. The new legislation may add more impetus to the development of the investment fund industry. However, in the absence of more investible assets major breakthroughs cannot be expected in the short term.

16. The insurance industry is the second most important sector in the Serbian financial system after banks. Although insurance companies form the largest domestic institutional investor group (6.3 percent of financial sector assets), the sector is still underdeveloped in a regional and European comparison. Total assets of the insurance companies amounted to 5.2 percent of GDP in 2017. In 2016, the penetration ratio (gross written premium as a percentage of GDP) was 7.2 percent on average in the EU compared to 2.0 percent in Serbia. The density ratio (the average premium per capita spent on insurance) was USD 134 in Serbia, significantly below the average amount in the EU (USD 2,429). The market consisted of 17 insurance companies at the end of 2017. Four were engaged in life insurance, 7 in non-life insurance and six provided both services. The majority of technical provisions of the non-life and life insurance were invested in government securities (73.5 and 96 percent respectively at the end of 2017). There remains room for further growth of the sector, which could serve as an important area for strengthening the demand side of capital markets.[9]

17. Assets of Voluntary Pension Funds (VPF) continue to rise, albeit from a low base. At the end of 2017 there were four fund management companies in charge of managing the assets of seven VPFs. Assets of each VPF are kept with one custody bank. The VPF market is highly concentrated. Three funds account for more than 80 percent of the VPFs' assets. Unlike in the previous four years, in 2017 the main driver behind the rising volume of assets was increasing contributions.[10] At the end of 2017, the total volume of assets reached RSD 36.3 billion, which is more than a 10 percent increase compared to the previous year (Figure 6). Despite the continuous growth, the total size of the VPF industry is less than 1 percent of GDP.

[9] Source: Annual Financial Stability Report – 2017 (NBS).
[10] Total contributions in 2017 were RSD 3.2 billion while the amount of withdrawals was RSD 1.3 billion.

Figure 6. Total assets of VPFs (RSD million)



Source: NBS

18. The average return on VPFs' investment was higher than the inflation rate in 2017. The return on investment reached 4.7 percent in 2017. This figure was 10.4 percent in the last five years. Regarding the currency structure, at the end of 2017, 86.4 percent of total assets were invested in RSD-denominated instruments, while 13.6 percent were in foreign currency instruments. Serbian government bonds account for a large majority (83.6 percent) of the investments, which is an obvious consequence of the absence of alternative investable instruments.

19. The number of VPF members is very small due to low public awareness of the benefits of this instrument. Only one in nine employees is a member of a pension fund. The awareness of employees and employers of the existence of private pension funds and general knowledge of the benefits of this long-term savings instrument is very low. Nevertheless, it also means that there is significant room for growth of the sector. It is recommended to conduct well-organized campaigns to inform the population of the advantages of private pension funds, including the relevant tax exemptions[11], which may help increase the awareness of VPFs.

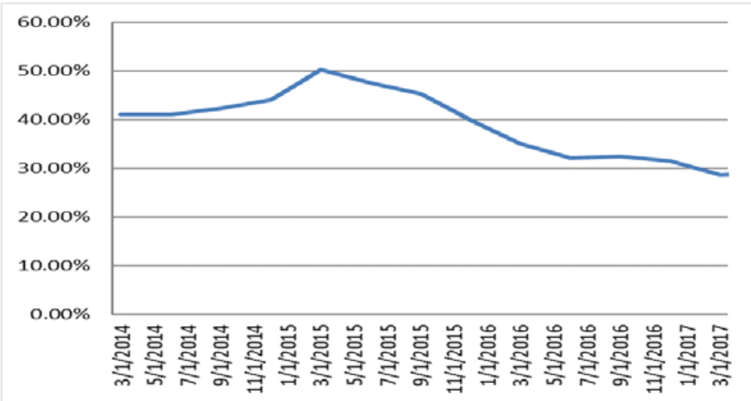
20. Foreign investor participation in the capital markets has fallen since 2013 but remains significant. Foreign investors' participation in the stock market, calculated based on the CSD classification, declined between 2013 and 2015 but has stabilized at around 40 percent since then (Figure 7). However, since the trading volume is very low, the volume of foreign investors' trading in nominal terms is small. The share of holdings of foreign investors in RSD-denominated government securities has been declining from the 50 percent peak in early 2015 but is still close to 30 percent (Figure 8). This makes them the second largest investor group in this market segment.

[11] Contributions to VPFs from employers' funds up to RSD 5,589 per employee per month are exempt from household income tax and contributions for mandatory social insurance.

Figure 7. Foreign investors participation in the BELEX equity and bond trading

Source: BELEX, calculated based on the CSD classification

Figure 8. Non-resident holding in RSD denominated government securities (%)



Source: PDA

21. Given the expected inclusion of RSD-denominated government securities in the JP Morgan GBI, foreign investors may increase their market share in domestic government securities. However, the lack of investment alternatives as well as the absence of sizeable public corporate bond issuances and IPOs constrain greater participation in non-government markets. The establishment of a Central Securities Depository (CSD) link between the local CSD with at least with one of the International CSDs (ICSDs) could be considered once foreign participation grows and the market size increases. Those conditions would need to be met to justify the costs.

22. Complicated tax procedures are another barrier for foreign investors when accessing the Serbian markets. As far as the taxation regime is concerned, the most significant obstacle is the obligation that non-residents must appoint a local tax representative. The local tax representative can request a tax identification number for the non-resident investor; however, he/she is jointly responsible for paying taxes (i.e. if the non-resident investor fails to pay taxes the local representative must do so). Because of this extra responsibility it is very difficult find appropriate representatives and the cost is very high. It is therefore recommended that the tax procedures for foreign investors be reviewed and streamlined to attract additional foreign investors, particularly to the government bond markets.

23. Retail investor confidence was negatively impacted by the stock market decline after the GFC and has not yet recovered. Individual investors suffered considerable losses during the GFC which caused them to be more risk averse. Primarily because of the mass privatization program, individuals had significant holdings of stocks and mutual funds before the crisis—most of the funds invested their assets on the stock market. Individuals now keep their investments mostly in bank deposits, particularly in FX deposits (EUR & USD), even though the currency has been quite stable in recent years. Although individuals were more active on the stock market before the crisis, their awareness of alternative financial instruments is still very low, which reduces the potential growth of the asset management industry.

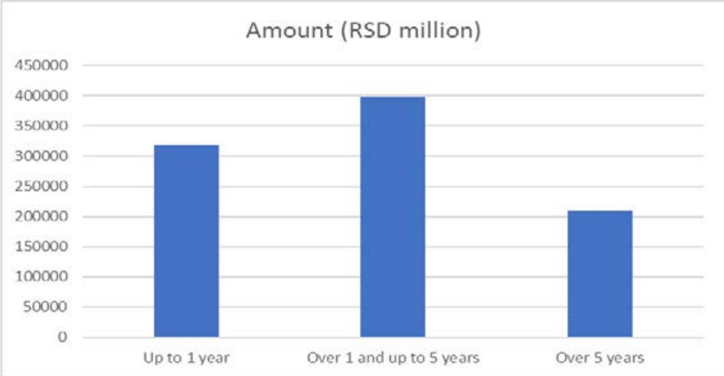
B. Supply of Issuers

Current arrangements

24. **Significant constraints exist on the supply side, with an extremely limited pipeline of potential issuers.** Serbia's corporate debt and equity markets lack large, profitable, quality private issuers. Prospective issuers are mainly SOEs, SMEs with good business models, and international financial institutions. Following the intense privatization program in the first half of the last decade, the number of potential SOE issuers is low, however some of them are sizable (e.g. Telekom Srbija, Elektroprivreda Srbije). However, they are conveniently financed by commercial banks with attractive conditions. Currently there is no outstanding corporate bond issued by an SOE. SMEs are responsible for several small private placements; however, the total volume is still very small. Commercial banks have not issued corporate bonds in recent years. At the end of 2017, there was no outstanding corporate bond issued by commercial banks. The majority of the banking system is foreign-owned, which allows Serbian subsidiaries to benefit from financing from their parent banks. Domestic banks have been able to finance the increase in their loan portfolio from the growing deposit base, rendering corporate bond issuance unnecessary. EBRD's bond issuance in 2016 was the only public non-government bond issuance since 2015.

25. **Commercial bank loans are the preferred and sometimes the only available option for corporate financing.** While the legal and regulatory framework is in place, potential issuers do not even consider financing themselves through the corporate bond market. There are significant constraints on the supply side, predominantly: i) the low awareness of alternative financial instruments, and ii) the easier, faster and cheaper procedure of obtaining bank loans. The absence of a diversified investor base, which would demand a wider range of capital market instruments, is another significant constraint to issuance. The only sizeable potential investor in the corporate bond market is currently the commercial bank sector, which prefers to finance corporates via their own products. In the first 11 months of 2017, new bank loans to non-financial corporates amounted to RSD 926.9 billion, more than 75 percent granted for less than five years (Figure 9). The longest maturity offered to corporates is 30 years. The current size of the mutual fund and VPF industry is too small to be able to contribute to the development of the corporate bond market.

Figure 9. New loans by maturity to non-financial corporates (January - November 2017)



Source: NBS

26. Although the number of companies listed on the BELEX peaked at above 2,500 in 2007 as a result of the mass privatization process (MPP), the number of listings has been declining continuously since then. As of December 2017, there were only 7 companies listed on the Regulated Market, the main board of the exchange. There have been no Initial Public Offerings (IPO) on BELEX since 1940 until recently, when at the end of October 2018, Fintel Energija successfully conducted an IPO.

27. The corporate markets suffer from both demand and supply challenges, but the biggest constraint for corporate market development is the lack of supply, notably the lack of companies suitable and willing to issue securities. Finding ways to grow and finance companies and develop the corporate sector as well as the investor base will be important. In the absence of these preconditions being in place, the focus for capital market development should be on improving the operation of the money market and the government bond market.

III. Analysis by Market Segments

A. Money Markets

28. Money markets are an important building block for the capital markets. An efficient money market improves the effectiveness of monetary policy, enhancing a country's economic potential, and is crucial for commercial banks' smooth liquidity management operations. Well-functioning money markets, among others: (i) enhance the effectiveness of liquidity management tools of the central bank and commercial banks; (ii) enable market makers to finance their government securities portfolios by using securities as collateral, which eventually supports them in carrying out market making activities and thereby enhance market liquidity; and (iii) provide price references for the short-end of the yield curve and for the creation of products such as floating rate bonds and hedging tools (e.g. derivatives, particularly interest rate swaps) that further facilitate the development of capital markets.

Current arrangements

29. The National Bank of Serbia (NBS) adopted an inflation targeting regime as of January 1, 2009. The main objective of the inflation targeting regime is to maintain a low, stable and predictable inflation rate, to support economic development. NBS has set the inflation target at 3 per cent, with a tolerance band of ± 1.5 per cent until the end of 2021. The main monetary policy instrument for inflation targeting is the key policy rate. The key policy rate (3 percent at the end of December 2018) is the interest rate applied in one-week reverse repo operations. Other policy instruments have supporting roles to facilitate monetary policy transmission via the key policy rate.

30. The NBS applies different policy instruments to support the implementation of monetary policy. The following tools help the central bank manage and control the liquidity position of the banking system:

a. Open Market Operations (OMOs): Outright purchase and sale as well as repo or reverse repo of government or NBS securities to manage interbank liquidity. The main OMOs are 1-week reverse repo transactions. Multiple price reverse repo auctions are conducted on a weekly basis, where the key policy rate serves as a ceiling which can be offered by the participating commercial banks. NBS sells its own, RSD-denominated securities for the purpose of reverse repo transactions.

Commercial banks substantially increased their average investments in NBS bills in 2017. The outstanding amount was RSD 45.1 billion at the end of the year, an increase from RSD 33.8 billion at the end of 2016.[12] One-week reverse repo rates are considered to be the most, if not only, reliable money market rate.

b. Reserve requirements: The amount of funds that banks are required to deposit with NBS. NBS specifies the ratio depending on the currency denomination and the tenor of the deposits as indicated in Table 3.

Table 3. Reserve requirements at end June 2018

	Up to 2-year tenor	> 2-year tenor
RSD	5%	0%
FX	20%	13%
FX indexed liabilities in RSD	100%	100%

Commercial banks are also encouraged to hold RSD liabilities through the remuneration of the reserve requirements—NBS remunerates only the RSD reserve requirements (1.25 percent at the end of June 2018).

c. Lending and deposit facilities: Overnight standing facilities available for banks at the ceiling or at the floor of the interest rate corridor determined with reference to the key policy rate:
   i. Rate on lending facility: key policy rate + 125 basis points
   ii. Rate on deposit facility: key policy rate – 125 basis points

Lending facilities include loans for maintaining daily liquidity (intraday and overnight), collateralized by eligible securities. Deposit facilities consist of excess liquidity deposits with NBS. Unlike deposit facilities, lending facilities are barely used.

d. Interventions in the foreign exchange market: A frequently used instrument. NBS' objective is to mitigate excessive short-term FX market volatility to ensure price and financial stability and maintain an adequate level of foreign exchange reserves. The NBS net purchased EUR 725 million in 2017 (EUR 1,355 million purchase and EUR 630 million sale).

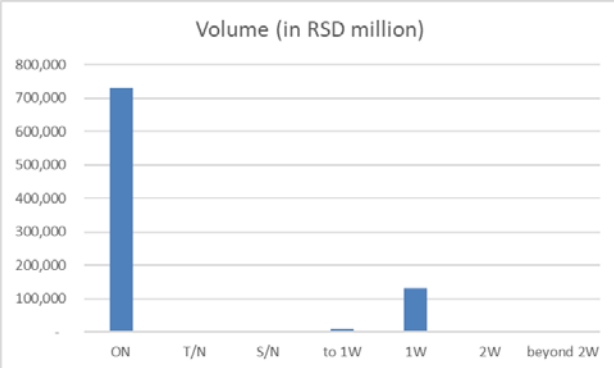
e. NBS can also provide short-term liquidity loans for commercial banks against securities as collateral. Liquidity loans can be offered via auctions for tenors up to 1-year. These auctions are not currently organized.

Commercial banks' major instruments to manage their liquidity are the one-week reverse repo and the deposit facility offered by NBS.

31. Interbank money markets, including the repo market, are active for tenors up to one week and illiquid beyond that, mostly due to a structural liquidity surplus in the Serbian banking sector. Unsecured overnight transactions account for most of the money market trades, significantly smaller amounts are traded between one day and one week. Longer tenors are exceptional and small in size (Figure 10).

[12] Source: NBS

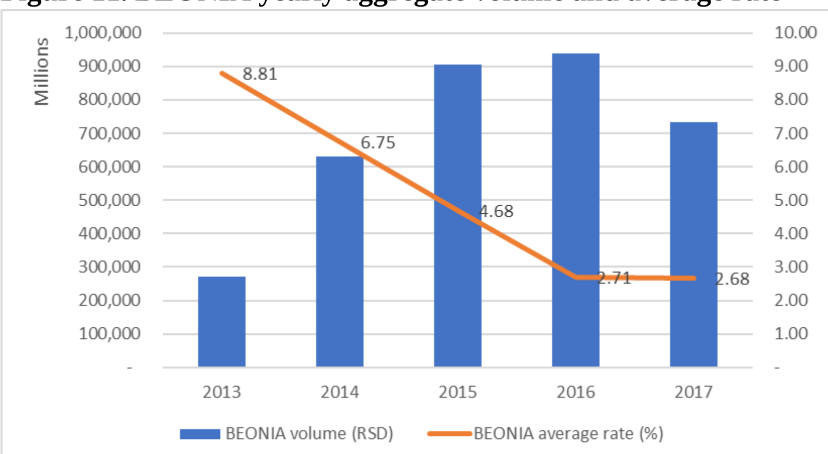
Figure 10. Volume of unsecured interbank loans in 2017



Source: NBS

32. **The most developed segment of the money market is the unsecured overnight interbank money market, however the liquidity of this segment is not high.** The effective overnight interest rate is called BEONIA. BEONIA is the volume weighted average interest rate of the unsecured overnight interbank loans.[13] Trading volumes in the interbank overnight market declined in 2017 compared to 2016 mostly due to increasing RSD liquidity of the commercial banks (Figure 11). The average BEONIA rates declined continuously in the past few years, reflecting the trend of the key policy rate. BEONIA usually fluctuates between the average NBS reverse repo rate and deposit facility rate. At the beginning of the reserve maintenance period it tends to be higher and then lower toward the end of the period.

Figure 11. BEONIA yearly aggregate volume and average rate



Source: NBS

33. **Rates other than overnight money market reference rates are represented by the Belgrade Interbank Offered Rate (BELIBOR).** BELIBOR is the benchmark rate offered on RSD deposits by panel banks in the interbank unsecured money market. The BELIBOR rate is calculated for T/N, S/N, 1W, 2W, 1M, 2M, 3M and 6M tenors.[14] Depending on the tenor, BELIBOR rates usually move between the average reverse repo rate and the key policy rate (Figure 12).

[13] BEONIA is calculated and published by NBS. Calculation of BEONIA is based on all concluded unsecured overnight interbank transactions reported by the lenders and borrowers to NBS.

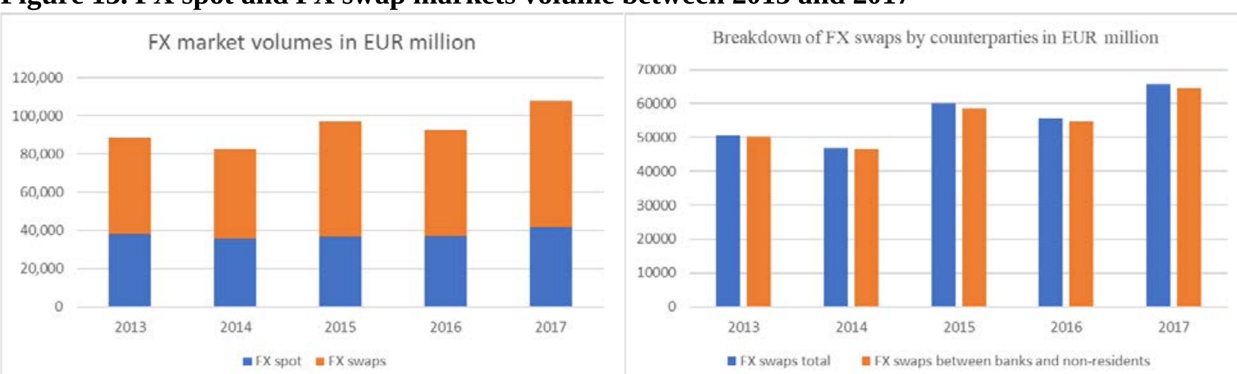
[14] At the end 2018, 10 panel banks contribute to the BELIBOR calculation. Rates are calculated and published by Reuters as an arithmetic mean of daily quotes, after the elimination of the two highest and two lowest rates.

Figure 12. Average BELIBOR rates 2013-2017 (%)

Source: NBS

34. The Serbian foreign exchange (FX) market consists of the FX spot[15], FX swap and FX forward market. The largest volume is traded on the FX swap market, mostly between local subsidiaries of foreign banks and their parent bank (Figure 13). Overnight transactions dominate the FX swap market, however other tenors up to 7-days are traded as well. Domestic banks and non-residents are the major participants in the spot market, while domestic corporates mostly buy or sell FX from or to domestic banks with value date shorter than 2 business days. Non-residents mostly consist of foreign banks, non-bank financial institutions and foreign institutional investors.

Figure 13. FX spot and FX swap markets volume between 2013 and 2017



Source: NBS

35. To support FX swap market development, the NBS organizes 2-week and 3-month EUR/RSD FX swap auctions every week under market conditions without predetermining the amount. The NBS always organizes two auctions at the same time: the purchase and sale of EUR against RSD with the same maturity and amount. NBS' intention is to enhance the liquidity of the FX swap market without impacting the overall banking liquidity. In 2017, NBS organized 100 3-month and 102 2-week FX swap auctions. The total volumes of the auctions were EUR 363 million and EUR 183.55 million respectively.[16] Domestic

[15] FX spot transactions might be settled up in to 2 business days.

[16] Source: NBS

corporates, mostly energy importers, account for most of the volume on the FX forward market. They buy foreign currency to hedge their FX exposure. FX forwards are usually traded up to 1-month tenor.

Pending issues

36. The repo market between commercial banks is basically non-existent. While the Association of Serbian Banks adopted the Global Master Repo Agreement (GMRA) in Serbian and English in 2014, only a few GMRAs have been executed since then. The number of transactions is negligible. According to the NBS, only three interbank repo trades were concluded until the end of 2017. The main reason behind the commercial banks' reluctance to sign GMRAs and trade on the repo market was the legal uncertainty caused by the lack of close out netting in the Law on Bankruptcy and the absence of appropriate regulation regarding financial collateral. However, the new Law on Financial Collateral[17] has been approved and came into effect from January 1, 2019. It will support the protection of creditors by allowing creditors in possession of the collateral or the pledge to exercise their ownership right over the collateral after the start of the bankruptcy procedure. This new regulation regarding financial collateral is expected to trigger the development of the interbank repo market. If commercial banks should remain reluctant to sign GMRAs between each other and to trade repos after the Law on Financial Collateral comes into effect, it is recommended to undertake a further assessment of the additional steps that should be taken to develop the repo market.

37. Money market liquidity needs to improve for short-term reference rates to provide a more reliable price reference. The NBS should take the lead on this process. BEONIA and BELIBOR should serve as short-term reference rates for money market participants. However, they are considered to be partially unreliable mostly because of the lack of liquidity. Even in the most liquid overnight segment, which is represented by the BEONIA, the average daily volume is low (Table 4). BELIBOR reform may improve panel banks commitment to quote firm rates. Currently, BELIBOR quotes provided by the panel banks are indicative, which significantly reduces the reliability of the reference rates. Instead, quotes should be executable, and trades should be enforced if bid and ask quotes cross each other.

Table 4. Average daily BEONIA volume

Year	Average daily volume in RSD	Average daily volume USD equivalent[18]
2013	1,075,960,317	10,544,411
2014	2,500,833,333	24,508,167
2015	3,590,305,556	35,184,994
2016	3,708,251,542	36,340,865
2017	2,905,289,683	28,471,839

Source: NBS

B. Government Securities Market

38. The government bond market is an important pillar for the development of capital markets. A sound government bond market: (i) provides a solid yield curve and price references for the valuation of investment portfolios and for the development of private sector products such as corporate bonds and structured securities (e.g. mortgage-backed securities); (ii) facilitates financial intermediation, making it easier for the private sector to issue debt with lower cost and risk; (iii) enhances the availability of instruments to support liquidity management by different market participants, including repo transactions;

[17] No 44/2018 of June 8, 2018
[18] 1 RSD = 0.0098 USD

(iv) provides low-risk investment assets for wholesale and retail investors; and (v) facilitates the implementation of monetary policy.

Current arrangements

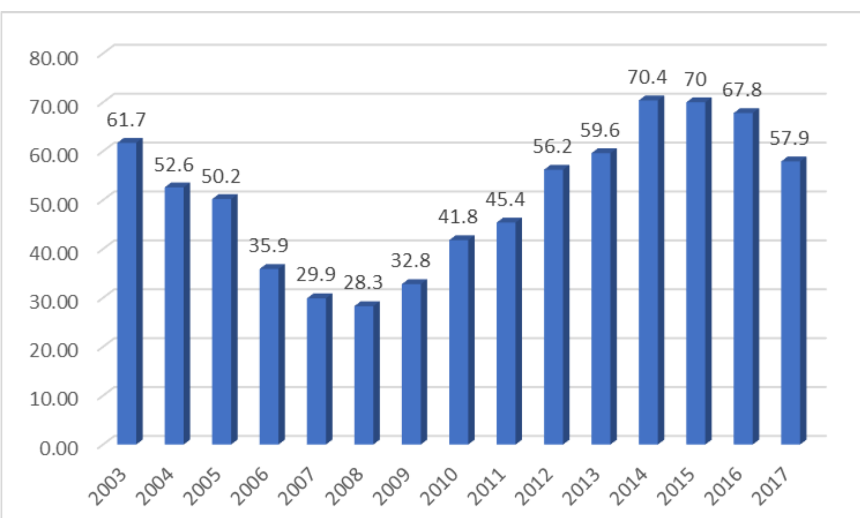
39. Government debt management functions are delegated to the Public Debt Administration (PDA), which is a separate administrative entity within the MoF. The legal basis for the establishment and operation of the PDA is provided by the Public Debt Law, the Budget Law and the Budget System Law. In accordance with the Public Debt Law, the PDA may borrow on behalf of the Republic of Serbia on the domestic or foreign market to finance the budget deficit, to refinance maturing debt and to finance investment projects. The primary objective of the PDA is to minimize the government's borrowing cost taking an associated acceptable level of risk.

40. Major objectives of the government's public debt management are defined in the Fiscal Strategy for the three-year period from 2018 to 2020. They can be summarized as follows:

- The share of RSD-denominated debt should be approximately 20-25 percent of total public debt;
- The share of EUR-denominated debt cannot be less than 60 percent of the foreign currency debt;
- The share of floating rate debt instruments should be reduced to below 20 percent in the medium term;
- The average time of refixing must be at least 4.5 years;
- The average time to maturity of domestic debt should be at least 4 years in the medium term;
- The average time to maturity of the external debt must be between 5.5 and 6.5 years.

41. After many years of an increasing public debt to GDP ratio, the upward trend reversed in 2016 and further declined in 2017. As a result of a strong fiscal consolidation, the central budget realized a sizeable RSD 33 billion surplus, which helped reduce the public debt to GDP ratio significantly (Figure 14). Furthermore, the weakening of the US dollar against the EUR substantially contributed to the declining debt to GDP figure in 2017. However, this also highlights the FX risk associated with the current currency composition of government debt.

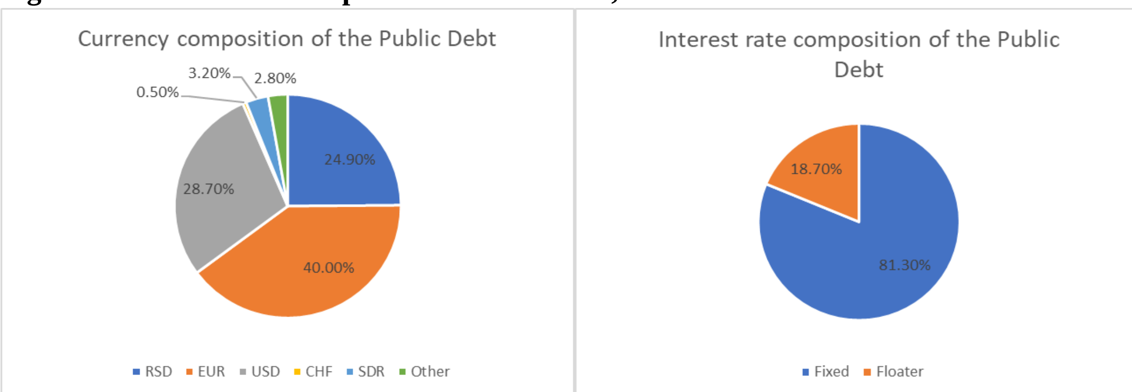
Figure 14. Public Debt to GDP (%)



Source: MoF – PDA monthly report

42. Serbia's government debt is highly exposed to foreign exchange risk. At the end of June 2018, FX debt accounted for more than 75 percent of public debt (Figure 15). Furthermore, the share of USD debt within the total debt is 28.7 percent on the same date, which means that the government debt portfolio is exposed not only to the RSD/EUR rate but also significantly to the EUR/USD rates. Nevertheless, the currency composition of the debt improved recently as the share of the RSD-denominated debt increased while the share of USD components declined since 2016.

Figure 15. Public Debt composition as of June 30, 2018

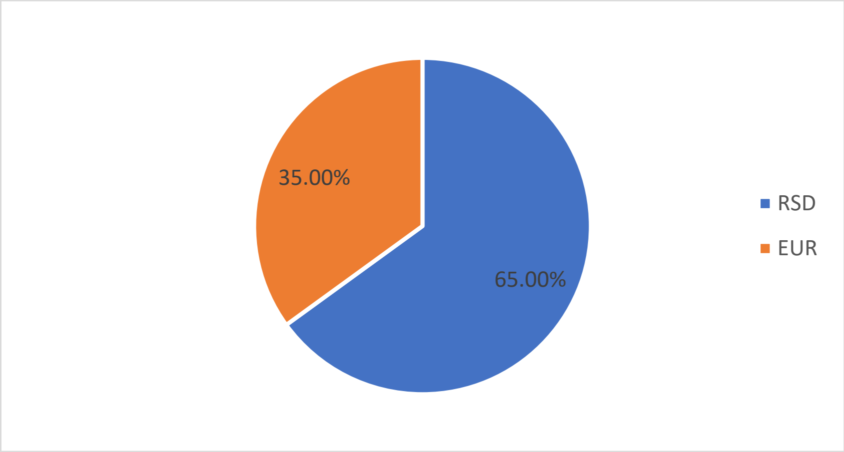


Source: MoF – PDA monthly report

43. In order to reduce foreign exchange risk, the PDA is considering cross currency swaps. The PDA has been discussing the framework for the derivative operation for a long time, supported by the World Bank Treasury. During 2018, the PDA signed ISDA Master Agreements with eight banks. The legal authorization is already in place, which allows the government to execute interest rate swap and cross currency swap transactions to mitigate the interest rate and foreign exchange risks of the public debt portfolio. The first USD-EUR cross currency swap transactions are expected to be conducted in 2019. The primary objective is to reduce the share of the USD-denominated debt.

44. Government securities are sold up to 10 years in RSD and up to 15 years in EUR in the domestic market. The MoF issues T-Bills for up to 2-year tenors and RSD government bonds for 2, 3, 5, 7 and 10-years. Single price auctions are applied. Non-competitive subscription at the cut-off price of the competitive auction is available for auction participants, however it cannot exceed 20 percent of the total issued volume. The government issues government bonds in EUR and RSD, however T-Bills are denominated only in EUR, mainly because there is lower demand from commercial banks for RSD T-Bills. The size of EUR-denominated government securities issuance is still significant in the domestic market (Figure 16), although the PDA is ready to support dinarization efforts if the execution of the issuance plan supports it. For example, although the PDA originally planned to issue EUR-denominated bonds in each month in Q3 2018, they were in the end removed from the quarterly plan. The objective of reducing USD debt and the focus on dinarization is welcome.

Figure 16. Currency composition of government securities issued on the domestic market as of June 30, 2018



Source: MoF – PDA monthly report

45. The PDA has been working on improving the transparency and predictability of primary market operations. A draft annual auction calendar is published for the whole year including the number of auctions for each available tenor in every month as well as the planned average amount of issuance per auction in the different tenors. Reopenings are also indicated in the yearly calendar. A quarterly auction schedule is published as well, which includes the auction date, the tenor, the coupon of the bond, the reopening and the offered amount.

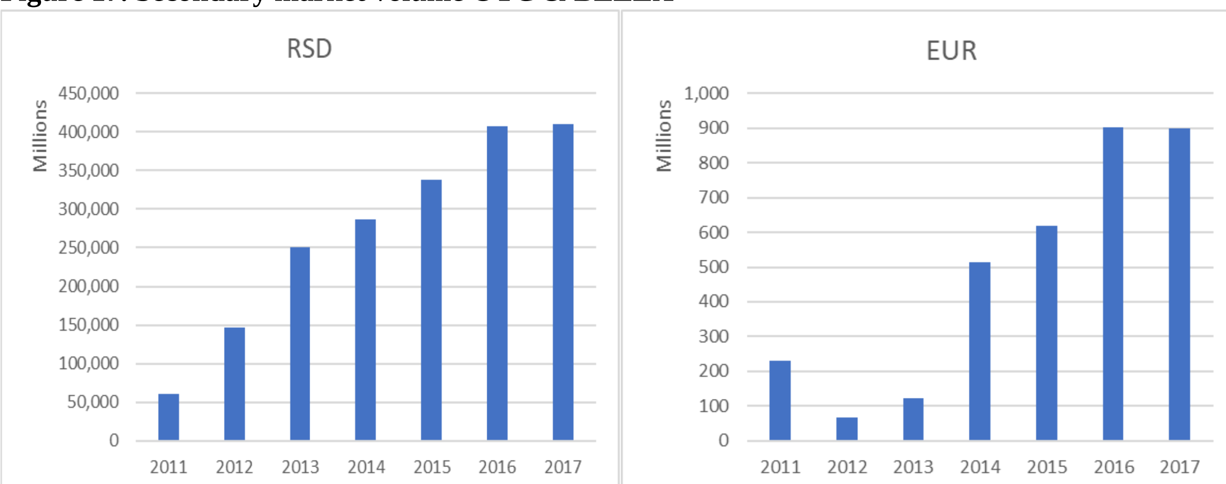
46. The sale of government securities on the domestic market has been smooth in 2018. Due to the heavy demand for primary auctions, the execution of the financing plan is on track. Demand for RSD-denominated bonds was extremely strong—the average bid cover ratio was 6.79 in the first 6 months. This figure stood at 1.77 for EUR-denominated bonds sold on the domestic market until the end of June.

47. The PDA has successfully introduced a benchmark building program for RSD-denominated government securities issuance. The first benchmark bond with a 7-year maturity was issued in February 2015. The target size was RSD 50 billion at that time. Following the successful implementation of the benchmark building program, the PDA significantly increased the target size to RSD 110 billion (roughly USD 1 billion equivalent) in 2016. That year a 3-year and a 7-year bond were issued in the benchmark volume. In 2017, another 3-year bond reached the target size. In 2018, a 5-year and a 10-year bond are planned to reach the benchmark target size. Because of the regular benchmark issuances, Serbian RSD-denominated government bonds are now very close to being included in the JP Morgan Global Bond Index. A promising sign is that JP Morgan has already opened credit lines for trading RSD-denominated government securities. The widely expected inclusion could trigger additional investor demand in sizeable amounts, which would help strengthen the domestic issuance program further.

48. A primary dealer system does not exist in Serbia, however primary market access is limited. Currently 11 local banks are eligible to participate in the auctions directly. The list has not changed since April 2016. The PDA has been considering the introduction of the primary dealer (PD) system, however local commercial banks show limited interest in it. The primary reason behind their reluctance is the potential market making obligation. Most of the banks do not trade on the secondary market at all—only 5-6 banks have some trading activity. Nevertheless, the PDA is committed to introducing a PD system in the next two years, however only with a soft framework in the first stage to allow banks more time to be prepared for the full-fledged framework. Up to 10 banks can be expected to join the PD system. While the implementation of the PD system could support the development of the secondary market, the lack of a diversified institutional investor base could jeopardize its viability and the smooth functioning of the system. A gradual implementation of the PD system would be appropriate for Serbia at the current stage.

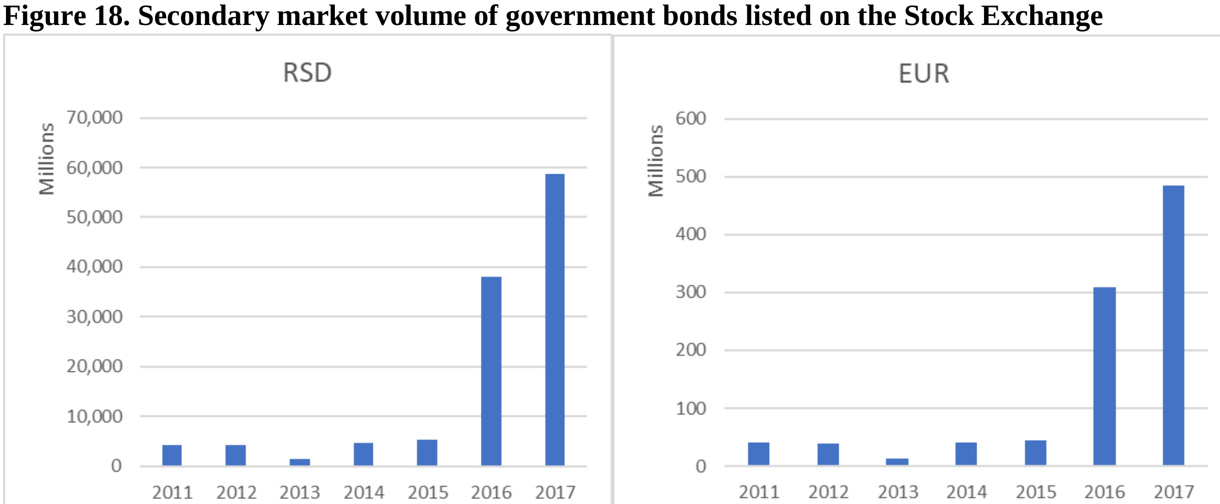
49. Although secondary market liquidity has improved significantly in recent years, the market remains shallow. As a result of the benchmark issuance policy, the secondary market volume increased significantly in the last two years (Figures 17 and 18). The secondary market basically not existed 5-6 years ago. At that time there were many days without any trades. Currently there is daily trading activity, particularly in the benchmark bonds, which helps in the development of a reliable yield curve.

Figure 17. Secondary market volume OTC & BELEX



Source: PDA

Figure 18. Secondary market volume of government bonds listed on the Stock Exchange



Source: BELEX

50. Government bonds are traded both on the Belgrade Stock Exchange and on the OTC market. Treasury Bills are not available for stock exchange trading. BELEX offers a centralized secondary market for government bonds. They are listed on the higher listing tier, in the Prime Listing category. Quotes are public, and trades are immediately visible in the trading system. Most of the trades are executed on the OTC market, however many trades are also conducted through the stock exchange, mostly so that stock exchange members would be able to increase their formal market share and improve their position in the stock exchange "league table". Furthermore, settlement of OTC trades is more expensive. BELEX members can reduce their trading costs by conducting OTC trades through the stock exchange. The share of the stock exchange trading is around 10 percent of the secondary market volume (Figures 16 and 17), however due to the huge drop in equity trading volume, government bonds accounted for 88 percent of the overall stock exchange turnover in 2017.

51. The main investors in domestic government securities are commercial banks and foreign investors. Commercial banks account for most of the demand for domestic government securities, particularly up to 5-years. However, beyond the 5-year segment their activity is much lower. Insurance companies mostly buy EUR-denominated bonds. The size of the pension fund industry is so small (roughly EUR 300 million) that their share in the government securities market is negligible. Foreign investors play an important role in the RSD bond market. Their share is around 30 percent of the total outstanding RSD bonds. However, foreign investors' demand for the domestic EUR issuance are negligible. They account for only 1 percent of the EUR-denominated domestic bonds.

Pending issues

52. While the PDA aims to adhere to the pre-announced yearly and quarterly auction calendars, it tends to be opportunistic in case of favorable demand with potential negative consequences. For example, on February 6, 2018, the PDA offered a RSD 10 billion 10-year bond and the total amount of bids was RSD 110 billion. Given the high demand, the PDA issued RSD 26.42 billion, i.e. more than 2.5 times more than previously announced. Although this kind of issuer behavior could have short-term benefits, it reduces the predictability of the issuance program and could have adverse impact on the secondary market as well as on investors' behavior because the outstanding volume will be significantly different from the one expected prior to the auction. It is therefore recommended that the PDA adheres to the pre-announced auction calendars.

53. Due to the successful implementation of the benchmark building program, the PDA will face increasing refinancing risk. The first benchmark bond issued in an amount of 1 billion USD equivalent will be due on February 22, 2019. According to the June 2018 quarterly report, the outstanding volume of this bond is RSD 108,67 billion. This amount accounts for more than 70 per cent of Serbia's cash buffer. Another benchmark bond with a slightly higher outstanding amount (RSD 110 billion) will be due in May 2020. According to international best practice, government debt managers who operate benchmark building programs often execute liability management operations to mitigate the increasing refinancing risk and to reduce the volatility of the Treasury Single Account. Liability management operations may include buybacks and/or switches of the old bonds as they approach their maturity dates. These transactions can be ad-hoc, but regular programs incorporated in the financing plan could be even more efficient. However, the implementation of these operations may take time as investors may not be immediately available for the early redemption of the bonds in sufficient amount. The PDA successfully conducted two buyback auctions in November and December 2018, reducing the outstanding amount of the bond maturing in February 2019 by RSD 20 billion. These are encouraging initial steps. It is recommended that the PDA considers introducing regular buybacks to reduce the exposure to actual market conditions and to create room for repurchases in larger amounts spread over a longer period of time depending on the government's liquidity position.

54. Although, there are regular, daily trading activities on the secondary market, an official yield curve is not yet published. This should be a priority for the PDA. Daily publication of the yield curve would support the valuation of government debt portfolios under the same principles for all market participants. Since trading data can be easily collected, the publication of the yield curve based on secondary market trades should be possible without difficulties. It is recommended that the yield curve be published as soon as possible.

55. Data on the secondary market turnover is overstated and does not accurately reflect real trading volume. Secondary market volume significantly jumps on auction settlement dates, because auction participants tend to settle the winning bids of the primary auctions with their clients in form of a secondary market trade. Although official data is not available on the overall size of that trade, according to market participants it accounts for a large share of the secondary market trading volume. Separation of the primary market trading volume is recommended as it would enhance the reliability of the secondary market trade data.

56. The expected inclusion in the JP Morgan GBI will likely increase foreign investors' share in the government markets. A higher share of foreign investors in the RSD government securities market may increase volatility and uncertainty due to the nature of foreign portfolio flows, particularly under stressful market conditions. Thus, the development of the domestic institutional investor base remains crucial.

C. Corporate Bond Market

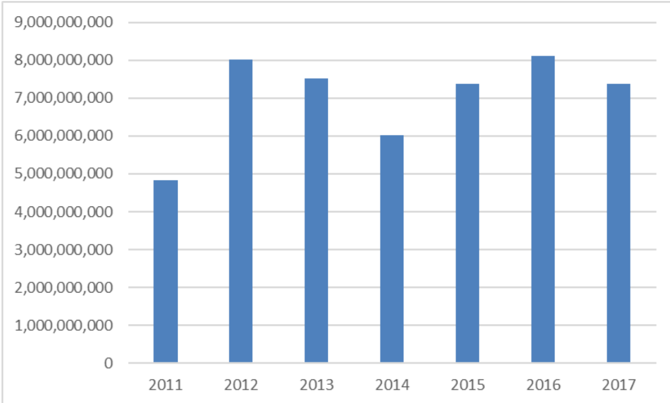
57. A non-government bond market can provide funding alternatives to private sector companies in the form of debt funding. A well-developed local currency non-government bond market supports financial stability and growth, enhances the pool of investable assets for different investor groups and supports the development of long-term investments in strategic areas such as infrastructure and housing.

Current arrangements

58. Serbia's non-government bond market remains nascent and extremely shallow. The financial system can be characterized as bank centered. Corporate financing is dominated by bank loans. While bank loans can also come with relatively high interest rates, high collateral demands, and insufficient availability of long-term loans, corporate bond issuance is considered by market participants as costlier than bank financing. The size of the corporate bond market is negligible. The outstanding volume of corporate bonds stood at EUR 38 million at the end of 2017, which accounts for only 0.1 percent of GDP. The size of the market has stagnated in recent years with the outstanding volume of non-government bonds more or less unchanged since 2012 (Figure 19). Rare corporate debt issuance in recent years has been through private placements.

59. In December 2016, EBRD issued a 2.5 billion RSD bond, the first local currency non-government bond issuance by an international financial institution. Although the size was not large, the issuance was well received. Investors in the bond consisted of domestic commercial banks and pension funds. The tenor of the floating rate bond is 3-year. One of the objectives of the transaction was to test the non-government bond issuance framework, which proved to be smooth and well-functioning. Another goal was to motivate the usage of the money market reference rates. Apart from EBRD's bond issuance in 2016, there has been no public non-government bond issuance since 2015.

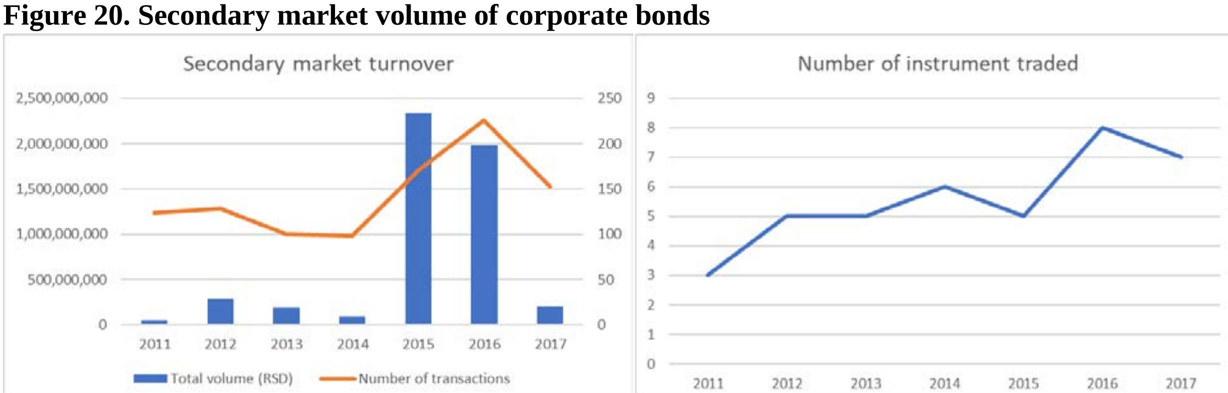
Figure 19. Outstanding stock of non-government bond debt instruments in 2011-2017 (RSD)



Source: CSD

60. The secondary market for non-government bonds is basically non-existent (Figure 20). Non-government bonds can be traded on the OTC market or on the BELEX, if they are listed. There is no listing obligation for non-government bonds, even if they are publicly issued with prospectus. If the issuer decides to request listing on BELEX, the stock exchange's decision takes not more 30 days. Currently, only the EBRD bond is listed on the regulated market. Two municipal bonds are available for trading on the MTP segment. Although BELEX has capped the trading fees for the government and non-government bonds (at RSD 5,000) to attract exchange trading of the debt instruments, there were no corporate bond transactions on the BELEX between 2015 and 2017.

Figure 20. Secondary market volume of corporate bonds



Source: CSD

61. The legal and regulatory framework for corporate bond issuance is in place and not considered to be an obstacle by intermediaries and potential issuers. The issuance of corporate debt instruments is regulated by the Law on the Capital Market, the Rulebook on the content of an application for approving a prospectus and the attached documents, and the Rulebook on the format, minimum information contained in the prospectus and base prospectuses and advertisements. Prospective issuers may decide to issue debt instruments in a public offering, in which case a prospectus must be submitted and approved by the SSC or through private placements without prospectus. The Law on Capital Markets provides several exemptions for issuers to choose private placements, for example: i) if the bonds are offered exclusively to qualified investors; ii) the offer targets fewer than 100 natural or legal persons; iii) the minimum amount of the offer is EUR 50,000 RSD equivalent per investors. A credit rating is not required for public issuers.[19] According to the Law on Capital Market, the SSC must make a decision on the approval (or rejection) of the prospectus within 10 days following the submission, which can be extended by an additional 20 days in case of first time issuers. Corporate securities can be issued in RSD or foreign currency, however in line with the Strategy of Dinarisation of the Serbian Financial System, local currency is preferred.

Pending issues

62. The corporate bond markets' contribution to financing the private sector is negligible. Given the absence of large, quality issuers, the supply side is weak. The commercial bank sector is dominated by subsidiaries of foreign banks, who do not seek financing from the local capital markets. In case of corporates who need financing in form of debt, the awareness of financing instruments other than loans is limited. Potential issuers do not fully understand the benefits of corporate bonds over loans from commercial banks. The major benefits are, among others, a convenient cash flow structure, flexibility of tenor, and direct access to the investor base. However, potential investors in corporate bonds are mainly commercial banks given the weak institutional investor base, and they prefer to finance the private sector via their loans. The focus for corporate markets should be on the development of the private sector, and the growth of the institutional investor base. Some technical measures are mentioned below, however without the preconditions for the development of the market in place, they are unlikely to be impactful in the short and medium term.

63. While the legal and regulatory framework for private sector bond issuers is in place, corporate bond issuance procedures are perceived as complicated and taking too long. Commercial banks can lend to corporates under a much smoother procedure and within a significantly shorter period of time. Even though the length of the SSC procedure is no longer than the average in the international practice, local companies consider bank loan negotiations to be a much quicker process, taking into consideration the preparation phase as well.

64. The issuance of corporate bonds, particularly with prospectus, is considered to be expensive and costlier than bank loans. According to the SSC, the transparency obligation is perceived as the biggest burden, the cost of which amounts to 30 basis points or so annually. Together with the cost of the SSC approval process, a corporate bond issuance would be more expensive than a bank loan. EBRD considered supporting a local bank to issue a corporate bond, however the final expected cost of the transaction was so high that the idea was dropped.

65. Unlike government securities, there is no tax exemption on the interest revenue and capital gains of corporate debt instruments. Government securities are fully exempt from any tax obligation, while interest earned on corporate bond investments is taxed. This, on one hand, increases the cost of issuance as investors will expect higher returns from the investment, and, on the other hand, discourages potential investors, also taking into consideration the complicated and cumbersome tax administration framework.

66. Individual and domestic institutional investors' demand for investing in corporate bonds is extremely limited. Due to low financial awareness and after suffering significant losses during the crisis, individual investors avoid any risky investments and prefer commercial bank deposits or hard currency cash investments. As for the domestic institutional investor base, their small size limits their investment

[19] There is only one prospective non-government bond issuer who currently has a credit rating, which is the Municipality of Belgrade, however no bond issuance has been executed by the capital city yet.

capacities in non-government bond instruments. A more diversified domestic investor base would be necessary to further develop the market.

D. Equity Market

Current arrangements

67. The equity market developed with the mass privatization program (MPP), which saw almost 4,000 companies listed, but until recently there was no IPO on the exchange since 1940. The MPP took place in four stages, mostly in the decade prior to the GFC. More than 600 companies were privatized between 1991 and 1994, including some smaller ones which might not have gone public otherwise. Between 1997 and 2001 more than 700 companies were privatized. There was a further round in 2001 and a final round in 2010. The process created six million investment accounts, the majority of which are dormant or inactive. Thanks to the privatization process, the equity market became more liquid in the period leading up to the GFC, attracting foreign investors and investment from domestic mutual funds. The crisis exposing a number of new shareholders (mostly individuals) to huge losses on their shares within a short period of time. The BELEX 15[20], the BELEX blue-chip index, plunged by 75.6 percent while the general BELEXLine[21] dropped by 68.7 percent in 2008.

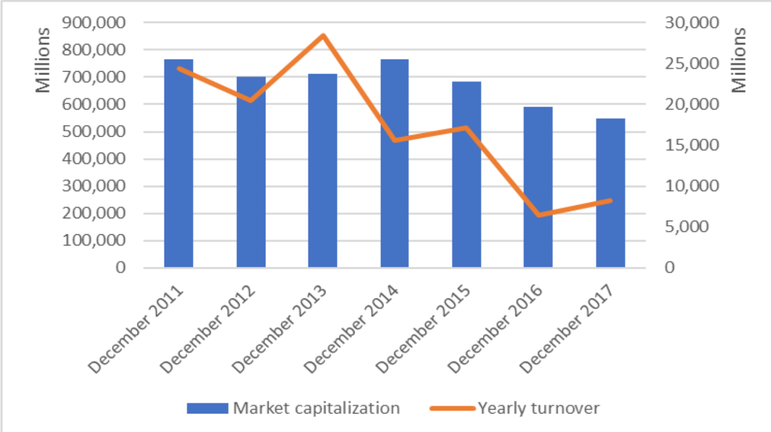
68. BELEX acts as the market operator for the Regulated Market and the MTP. BELEX offers a balanced structure of stock exchange segments tailored to meet listed companies' needs depending on their size, growth potential and funding needs. Companies can be listed on the Regulated Market or on the MTP. The Regulated Market is divided into four segments: i) Prime Listing; ii) Standard Listing; iii) SMart Listing; and iv) Open Market. Prime Listing is the top category, available for companies that can meet more stringent requirements. Standard Listing has been designed for companies that fail to meet the criteria for Prime Listing but are attractive enough to access the capital market through the stock exchange. SMart Listing has been introduced to enable SMEs and start-up companies to raise capital under the stock exchange framework; however, no companies have been added to this category so far. The Open Market category is not an official listing segment but provides a trading platform for the companies that want to benefit from the BELEX infrastructure.

69. The capitalization of the BELEX has been declining. The capitalization of the equity market was RSD 548.87 billion (EUR 4.63 billion) at the end of 2017 (Figure 21). This is slightly less than 12 percent of GDP. The daily trading activity and the aggregate volume of trades are negligible. In 2007, prior to the crisis, the equity market was a prosperous segment of the Serbian capital markets. The daily stock exchange turnover averaged around EUR 10 million. This has declined to EUR 250,000 by now.

[20] BELEX15 includes a minimum of 7 and a maximum of 15 shares traded on the Regulated Market of BELEX. The share of one component cannot exceed 20 percent of the capitalization of the index. At the end of June 2018, BELEX15 consisted of 11 shares.

[21] BELEXLine is the general BELEX index consisting of shares traded on BELEX and meeting the inclusion criteria. Influence of the components is limited to 10 percent of the index capitalization. At the end of June 2018, BELEXLine consisted of 24 shares.

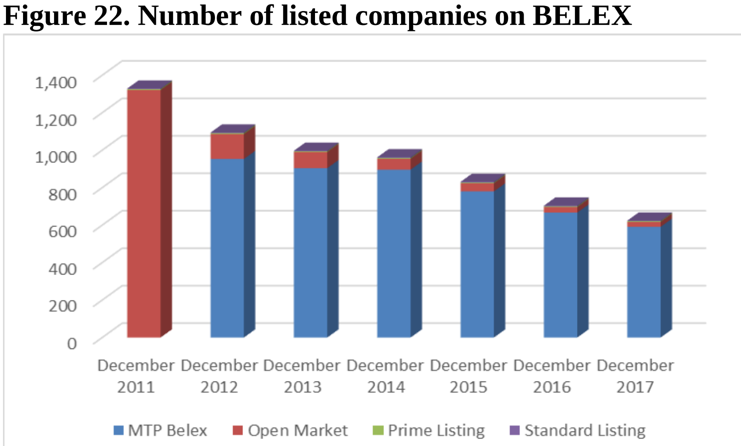
Figure 21. BELEX market capitalization and trading volume 2011-2017 (in RSD)



Source: BELEX

70. The number of companies listed on the BELEX peaked at above 2,500 in 2007 but has been declining continuously since then. Of the 2,500 companies listed, more than 1,900 were delisted either voluntarily or through bankruptcy. This also led to a draining of liquidity. Currently, there are less than 600 listed companies, however most of them list on the MTP market because most of the shares fail to meet the listing criteria[22] of the Regulated Market (Figure 22). Delisting accelerated a couple of years ago when the squeeze-out rule was amended[23] and the squeeze-out ratio was reduced from 95 to 90 percent. Majority shareholders of several listed companies tried to take advantage of the new threshold and applied the mandatory purchase of shares even on the dormant accounts.[24] As of December 2017, there were only 7 companies listed on the Regulated Market (4 Prime Listing and 3 Standard Listing) and 26 on the Open Market. Shares of 591 companies were available on the MTP segment.

Figure 22. Number of listed companies on BELEX



Source: BELEX

71. At the end of October 2018, Fintel Energija successfully completed Serbia's first IPO since 1940. More than 1.5 million shares were issued, which was the minimum threshold for a successful process.

[22] For example, minimum free-float, average daily turnover.

[23] A squeeze-out refers the compulsory sale of the shares of minority shareholders for which they receive a cash compensation.

[24] Many individuals are not even aware of being shareholders as a result of the privatization.

The company raised RSD 755.2 million for the development of their business and expansion of their network of wind parks in Serbia. Shares of Fintel Energija have been admitted to the Prime Listing section.

72. In January 2018, BELEX launched the so-called IPO Go! Project[25], which aims at initiating and supporting IPOs. The main objective of the project is to increase the supply of securities and investment alternatives on the stock exchange. The estimated duration of the program is 14 months. The project focuses on identifying two to three prospective companies that have the potential to raise capital through an IPO and that, following the IPO, could be listed on the BELEX. The identified and selected companies will be supported in the process towards the eventual stock exchange listing. The program does not have a sectoral focus; however, the companies must be visible and well recognizable with a good track record and an appropriate governance framework. Approximately 30 companies have been identified as potential candidates. BELEX and PwC plan on narrowing down the number further. The project is expected to be completed with at least one IPO by March 2019.

73. In December 2016, BELEX joined the SEE Link network, enabling trading on multiple markets participating in the network. SEE Link was set up by three regional stock exchanges with the support of EBRD in 2014: the Bulgarian Stock Exchange, the Croatian Stock Exchange and the Macedonian Stock Exchange. Since the launch of the network, five more stock exchanges have joined, including two stock exchanges from Bosnia and Herzegovina, Ljubljana Stock Exchange from Slovenia, BELEX and just recently Greece. The combined capitalization of the SEE Link network stock exchanges exceeds USD 50 billion including almost 1,200 securities listed on the seven stock exchanges.[26] Although, the objective of the project is to increase the trading volume on the member stock exchanges, it has not contributed to the BELEX turnover so far. Other countries have not benefited much from the operation of the platform either mainly due to the high costs of trading and the cumbersome clearing and settlement arrangements. The regional collaboration among the stock exchanges could enhance the stock market liquidity in the involved countries, however the different legal and regulatory frameworks, the lack of CSD links as well as the different currencies create challenges for market operators.

Pending issues

74. The most severe challenges of BELEX and the equity market are the small number of listed companies, the lack of IPOs and the absence of liquidity as well as trading of the listed companies. Serbia has not had any IPOs for decades until recently. The government has never used IPOs for privatization purposes. Private companies have not raised capital through IPOs either. Together with the high number of delisting in the recent years, BELEX is suffering from the absence of attractive investment alternatives.

75. Currently there seems to be limited potential for the equity market of the BELEX. As of December 2017, only seven companies remained on the Regulated Market, there are no large IPOs in the pipeline, and the corporate sector does not consider funding in the form of capital. Government bond trading accounts for a large share of the turnover of BELEX.

76. If the recent initiatives for IPOs are successful and a few more demonstration transactions can be realized, it may encourage other domestic corporates to seek financing through raising capital.

[25] The IPO Go! project is supported by the EBRD. PwC is the consultant firm for the program.

[26] Securities listed on the SEE Link member stock exchanges can be traded via executing broker companies which have trading rights on the local markets. CSDs of the particular stock exchanges are not connected; settlement and clearing are provided through the executing broker company.

This could strengthen the equity market and improve the liquidity of the stock exchange. Nevertheless, without large IPOs, one or two transactions will not change the current picture of the stock exchange and improve the attractiveness of the market significantly. However, at least it would demonstrate the development potential of the Serbian capital markets. If these initiatives work well, the authorities and other involved entities should assess how they can replicate the successful IPOs. Furthermore, other options, such as including governance standards, the time and cost of IPOs, listing requirements, and issuer and investor education should be assessed in terms of how they can support the growth of the corporate sector and companies that could issue securities and how these private sector corporates can be encouraged to consider funding via capital markets instead of bank loans.

77. Many Serbian individuals are not aware that they are shareholders of privatized companies. The number of dormant accounts is very high, exceeding 5.7 million. The total value of the dormant accounts is EUR 2.88 billion equivalent.[27] The owners of these accounts either do not care or do not know about their ownership of those securities and they do not even collect their dividends. These dormant accounts could potentially boost the liquidity of the equity market, as a large portion of free float is held in those accounts. It is recommended that a strategy be put in place to resolve the dormant accounts.

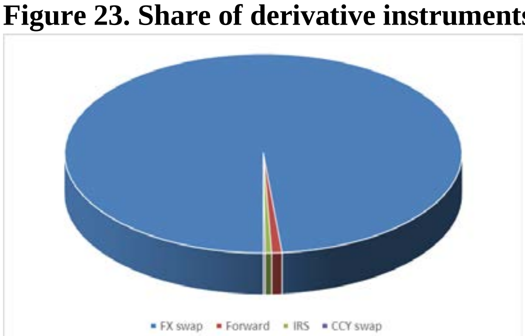
E. Derivative Markets

78. Derivative markets can provide efficient risk management tools for investors and companies who have exposure to financial risks. With the use of derivatives, issuers have access to alternative sources of funding (e.g. domestic versus foreign currency; fixed versus floating rate instruments). Large and frequent issuers can diversify their funding profile while investors can extend their investment profile towards a wider range of instruments providing liquidity for riskier assets as well.

Current arrangements

79. In the Serbian derivative markets, the most commonly used instruments are FX swaps and FX forwards. FX swaps are mainly conducted between local subsidiaries of foreign banks and their parent bank to support the liquidity management of the local bank. The NBS introduced weekly FX swap auctions to promote the development of this market, however most of the transactions are still executed with non-residents. FX forwards trade mainly between domestic banks and domestic corporates, where companies buy and to a smaller extent sell foreign currency to hedge their FX exposure. However, the size of this market is much smaller than that of the FX swaps (Figure 23). Derivative trading is not available at the BELEX. Transactions are therefore executed on the OTC market.

Figure 23. Share of derivative instruments based on the total volume traded in 2017



Source: NBS

[27] Source: Cross Regional Dormant Accounts Study, EBRD, 2017 November.

Pending issues

80. Derivative markets in Serbia are underdeveloped and illiquid. Although the Decision on Performance of Financial Derivative Transactions (RS Official Gazette, No. 76/2018) allows residents to perform transactions in financial derivatives for the purpose of hedging against exchange rate risk, interest rate risk, securities risk, commodity price risk, and stock market index risk, the development of derivative instruments lags behind.[28] Given the underdevelopment and the lack of liquidity of the equity markets, the potential of derivative market development is very limited. While the derivatives market could contribute to the liquidity of the bond and equity markets and could support the development of the risk management (hedging) tools, it would require a certain liquidity in the underlying bond and equity markets, which currently does not exist in Serbia.

81. Derivatives market development requires more reliable short-term reference rates, which are based on liquid money markets. Short term rates other than BEONIA are considered to be illiquid and partially unreliable. BELIBOR quotes are indicative and not enforceable, which reduces the reliability of the fixings. In the absence of money market liquidity and reliable money market rates, the pricing of derivative instruments is difficult.

82. Adverse taxation rules on interest rate swap transactions discourage market participants from using this hedging tool. According to market participants, the major reason behind the underdeveloped and illiquid interest rate swap market is the adverse taxation framework. Interest payments and revenues on the payer and receiver legs of the interest rate swap transaction cannot be netted; both counterparties have to pay the full tax on the interest revenue they receive. This arrangement significantly increases the cost of interest rate swap transactions.

IV. Enabling Environment

A. Market Infrastructure

Current arrangements

83. Financial market infrastructure facilitates the functioning of the financial markets by providing clearing, settlement and recording/depository services. Post trade financial market infrastructures include the payment system, the central securities depository, and the securities settlement system. In Serbia, the payment system is mainly operated by the NBS. At the moment, besides the NBS, which operates five payment systems in the Republic of Serbia (RTGS Payment System of the NBS, Clearing Payment System of the NBS, IPS Payment System of the NBS, Interbank Clearing System of Foreign Exchange Payments and DinaCard Payment System), the Association of Serbian banks operates two payment systems (ASB Cheque Clearing System and ASB Direct Debit Clearing System). The central securities depository and the securities settlement system are operated by the Central Securities Depository and Clearing House (CSD).

84. The NBS RTGS is the payment system for the transfer of RSD funds in real time at gross principle among its participants. The real time gross settlement helps system participants to adequately manage their credit risk. The system also supports participants to manage their liquidity risk, enabling them to view their transactions, account balances and changes in the sequence of execution of payment orders in

[28] Transactions may be traded and/ or made outside the regulated market and/or multilateral trading platform.

real-time. Furthermore, the NBS provides intra-day free-of-charge loans upon request of the participating bank(s), collateralized with eligible RSD-denominated securities, which can be NBS Bills, government securities or IFI securities.[29]

85. The CSD's primary function is to provide infrastructure for the registration, clearing and settlement of transactions with financial instruments. The CSD was established in 2001 as a division of NBS and was transformed into a joint-stock company fully owned by the Republic of Serbia in 2003. According to the Law on Capital Market, members of the CSD may be the Republic of Serbia, NBS, investment firms, credit institutions, market operators, regulated markets, fund management companies, and foreign legal entities that perform clearing and settlement or registration. At the end of 2017, the number of CSD participants was 49, of which 21 were brokerage companies and 26 commercial banks as well as the Republic of Serbia and NBS. All members were domestic entities at that time. The CSD is a member of the ANNA[30] and in this role is responsible for assigning ISIN codes to Serbian financial instruments. The main responsibilities of the CSD related to financial instruments are the following: i) proper registration, ii) record keeping, iii) transfer, iv) registration of third parties' right, v) clearing and settlement of transactions, vi) corporate actions, and vii) depositing securities.[31] The CSD is also responsible for servicing the dormant accounts without the opportunity to charge safekeeping or servicing fees. The CSD had to invest heavily in their infrastructure to be able to service the dormant accounts and the prohibition on charging fees makes this function costly and burdensome.[32]

86. The CSD can settle different settlement flow types and supports FoP, DvP and DvD transactions. The settlement cycle on BELEX is T+2, however the CSD can settle transactions for T+0 or T+1 as well, based on the agreement of the involved counterparties. The CSD does not use SWIFT, but electronic messages for data exchange with participants in SWIFT-like format. In Serbia, all securities are dematerialized by law.

87. Integration with the international infrastructure for clearing and settlement is essential to accelerate the integration of the domestic government bond market with the international markets. Currently, neither Euroclear nor Clearstream bridge accounts exist with the Serbian CSD, which limits the access of foreign investors to the Serbian capital market. Should Serbia enter the JP Morgan Index, and as volumes increase, integration with international clearing and settlement will be important.

B. Regulatory and Supervisory Framework

Current arrangements

88. The Serbian capital market is regulated and supervised by the SSC. The SSC is an autonomous and independent organization of the Republic of Serbia. It regulates and supervises local capital markets structures and infrastructures, capital markets intermediaries, public offerings, investment funds and their managers, in accordance with the principles set in the law and regulation prepared by the MoF. Regulation does not require credit ratings for bonds and there are no credit rating agencies in the country. Most up to date legislations and regulations are available in English on the SSC's website. The SSC is accountable to the National Assembly, which appoints the commissioners for a period of five years. Changes in regulation must go through a public consultation process. Its decisions are subject to judicial control via administrative

[29] Source: NBS Annual Financial Stability Report – 2017.
[30] Association of National Numbering Agencies.
[31] Source: CSD.
[32] Source: Cross Regional Dormant Accounts Study, EBRD, 2017 November.

appeal. The SSC is self-financed, dependent on fees charged to market participants. The NBS cooperates in the supervision of banks' operations in the capital market. Serbia is a signatory of IOSCO's Multilateral Memorandum of Understanding.

Public offering of financial instruments and shareholder rights

89. The SSC has adopted a regulatory environment which tends to be similar in structure to that of a developed market place. It includes rules for registration and the form and content of the prospectus, which incorporates audited financial statements of the last two years, and other documents related to the issuers' activities. The company and its management are accountable for the contents of the prospectus, while underwriters, agents, advisers and other experts are accountable only for their inputs in the prospectus. Exemptions from the public offering requirement are limited and regulated. Public companies are subject to corporate governance obligations stipulated in the Law of Companies and the Law on Capital Market. These include fair and equitable treatment of shareholders, accountability of company bodies to shareholders, transparency in operations and decision-making, professionalism and independence of the management bodies, timely and full disclosure of relevant information, and efficient control of financial and business activities of the company.

90. The regulation is set to protect shareholders' interest. Public companies are required to apply corporate governance standards as set under the Serbian Companies Law and Capital Market Law. Shareholder meetings decide on dividends, share capital increases and reductions, issues of securities, number of authorized shares, changes in rights or privileges attached to any class of shares, and on the appointment of directors and members of the supervisory. Shareholders must be given timely notice for meetings and have the right to give a written proxy to a person designated to attend meetings on their behalf, including the right to vote. Decisions abolishing pre-emption rights or decreasing share capital must be adopted by a three-quarter majority of shareholders in attendance. Shareholders holding 5 percent of shares have the right to propose amendments to the agenda and the right to convene an extraordinary meeting of shareholders. A takeover bid is obligatory for any person or group acquiring 25 percent or more of the voting shares. It must be made public within two working days of the day of the takeover obligation and filed with the SSC within 15 days. All shareholders of an offeree company must be afforded equivalent treatment and be properly informed in a takeover procedure.

91. Public companies are subject to reporting requirements. They are required to make their annual reports public and communicate them to the SSC and the regulated market or MTP. The reports include annual financial statements, prepared according to International Financial Reporting Standards (IFRS) and audited by an auditor[33] who is registered and overseen by an independent body, a report of operations of the company, and responsibility statements by those responsible for preparing the annual report. In addition, issuers are required to prepare public half-yearly and quarterly financial reports, which do not have to be audited. Public companies are required to publish and file with the SSC changes in rights attached to securities, changes in the number of voting shares and the value of core capital, acquisition of own shares, general meeting of shareholders, allocation and payment of dividends and the issue of new shares, decisions and minutes by a shareholder meetings, changes in the Statute or Memorandum of Incorporation, new issues of debt securities, changes in qualified holdings[34], inside information, and changes in disclosed inside

[33] To be eligible, auditors must comply with independence rules, have a license by the Audit Public Oversight Board and a certification by the Chamber of Certified Auditors. The Board is appointed by the Government, and supervises the application of accounting standards, the code of professional ethics and implementation of disciplinary actions by the Chamber.
[34] Exceeding or falling below thresholds of 5%, 10%, 15%, 20%, 25%, 30%, 50% and 75% in voting rights.

information. The Serbian Business Registers Agency also published information on financial statements and evaluations of the solvency of companies, cooperatives, institutions and entrepreneurs.

92. The SSC's Securities Department ensures compliance with all public offering legal and regulatory obligations. This Department is comprised of five persons supervising 33 joint stock companies admitted to the regulated market and 571 equity securities issued by 561 issuers on the MTP. There are 66 bonds issued by the Republic of Serbia and listed on the BELEX, one bond issued by the ERBD, and two municipal bonds.

Collective Investment Schemes local offer and funds' shareholder rights

93. The regulation applicable to local Collective Investment Schemes and their managers also seems close to the EU framework. All types of investments funds must be managed by a management company that is established in Serbia with a license issued by the SSC. Licensing requirements include the cash portion of core capital of at least EUR 125,000, clean origin and transparent capital structure, fit and proper requirements, and adequate organizational capacities, technical equipment and personnel. Management companies must register investment funds in the Register of Investment Funds. The company must already have a license for organizing close or open-ended funds, which requires a prospectus[35] and summary prospectus, Articles of Incorporation for closed-ended fund, contract with a custody bank, a list of persons to perform portfolio manager activities, and a contract on management for closed-ended funds. Fund registration requirements include a contract with an independent custodian bank licensed by the SSC, at least EUR 200,000 in assets in an account with this bank, evidence that no investment fund unitholder may acquire more than 20 percent of the net asset value for open-ended funds, and a certificate of the Register of Companies for close-ended funds.

94. The Serbian funds framework offers a decent number of funds categories with corresponding investment rules. They are targeted at investors in accordance with the type of risks. Open-ended funds may be growth funds, income funds, money-market funds or balanced funds. Close-ended funds are classified as investing in publicly traded companies as well as non-publicly traded companies and real estate. In general, all investment funds may invest in securities admitted to trading in a regulated market—domestic or foreign—or in the MTP, units of other open-ended funds—domestic or foreign—or in financial derivatives traded in a regulated market. They are subject to eligible asset rules in accordance to their strategy and classification, liquidity restrictions on foreign securities, concentration limits and risk diversification, and prohibitions to invest in metals or securities representing them, their management company and in the case of close-end funds, financial instruments or real estate of companies with which it has close links. Open-ended funds have a leverage limit of 10 percent of total assets with less than 360 days to maturity, whereas close-ended funds have no limits.

95. The legal and regulatory framework of investment funds requires sound and prudent business operations. It includes acting honestly, fairly and professionally in accordance with the best interests of the unit holders, best execution, disclosure of inside information, procedures to preserve confidential information, procedures to prevent conflicts of interest, etc. A management company may delegate administrative and marketing activities to other parties, but the company retains full responsibility

[35] Contents include fund name, type of fund, date of establishment, time and location of financial statements, tax treatment, investment goals, policy and risks, portfolio structure, information on purchasing and redemption, income and return distribution, calculation and publication of the net asset value, procedure for notifications of changes in fees and investment policies, grounds for dissolution, management company, the custodian bank, fees and expenses charged to the fund.

for their actions. The company has to inform the SSC of any delegated functions and the SSC must be able to supervise them. Net asset values (NAVs) must be calculated and are available to fund holders on a daily basis for open-ended funds and monthly for close-end funds. Asset valuation is made using fair value (FV). For shares, FV is calculated as the average weighted price for the last five days of trading in the share, over the last 180 days. If there are no five trading days in this period, then the lower value between the book value or the closing price on the last trading day is used. For debt securities, the closing price on the last trading day over the last 30 days is used. If there are no trades in this period, then the security's cash flows are discounted using the market interest rates of a security with similar maturity and credit rating. Purchase and redemption of units may be suspended if it is not possible to calculate its NAV because of extraordinary circumstances, persistent miscalculations or if redemptions exceed 10 percent of the fund's NAV and it is not possible redeem them in the period defined by law. The custodian bank controls and validates the NAV of each fund.

96. Management companies are subject to regular reporting. They have to publish and submit to the SSC annual audited financial statements for the company and the investment funds they manage as well as half-yearly reports for each fund. In addition, they must publish a statement on the balance and changes in investment units, financial indicators, and reports on the structure of fund's assets and on realized and unrealized gains/losses. In the case of close-ended funds, a report on transactions with related persons is also made public. Monthly, the company must also submit to the SSC reports with information on the NAVs and the structure of assets and costs of each fund and information on the management company (changes in staff capacities, capital, and assets). Furthermore, prospectuses must be updated twice a year to add recent financial information and may be updated more often if there are any significant changes. Private funds tend to be organized as limited liability companies and are not subject to general provisions on investment funds regarding issuance of licenses, asset management, custodian services, and reporting, except for annual financial reports.

Market intermediaries and investor rights

97. All investment services providers must be licensed. A license of investment firm, granted by the SSC, is required to provide investment services, which include reception and transmission of orders, execution of orders on behalf of clients, dealing on own account, portfolio management, investment advice, underwriting of financial instruments and/or placing of financial instruments on a firm commitment basis, placing of financial instruments without a firm commitment basis, and operation of MTPs. Investment firms may be broker-dealers or banks. Licensing requirements include an initial minimum capital[36], clean origin and transparent capital structure, fit and proper conditions, staff qualifications, organizational capacity, technical equipment, etc. There are no risk-based capital adequacy rules.

98. Investment firms are subject to operational and business conduct rules that tend to be similar to the EU post-MiFID environment. They have to apply Principles of Safe and Sound Business Operations, such as acting honestly, fairly and professionally in accordance with the best interest of their clients, disclosure of rules on business and fees to clients, "know your client", "best execution", protection of confidential information, recordkeeping, and separate accounts for clients' money and financial instruments in banks and the CSD. Also, intermediaries are subject to market abuse rules on market

[36] EUR 50,000 for reception and transmission of orders, EUR 125,000 for execution on behalf of clients, portfolio management, investment advice or placing financial instruments without a firm commitment basis, EUR 200,000 for dealing on its own account, EUR 730,000 for underwriting/placing financial instruments on a firm commitment or operating an MTP.

manipulation and insider trading. Investment firms must have an independent compliance function, internal control and risk management policies and procedures and measures. Firms with a required minimum capital of EUR 730,000, must have an independent and separate internal audit function. Banks authorized as investment firms are not subject to rules on capital levels, risk management, register of companies and qualified holdings.

99. Investor rights are dematerialized and registered at a central depository. In case of bankruptcy, the Serbian Bankruptcy Law, based on the UNCITRAL Model Law, applies. Any person, domestic or foreign, natural or legal, may acquire or dispose of financial instruments, including the rights arising from them. Financial instruments are registered as electronic records on securities accounts kept with the CSD, imparting to the lawful holder of the financial instrument specific rights in respect of the issuer. CSD members issue regular statements of balance and transactions. Exercise of creditors' rights are defined by the Law on Enforcement and Security Interest and introducing the Public Enforcement Officers. The average time to exercise creditors' rights has decreased from 635 to 95 days (2016) according to the Chamber of Enforcement Officers. The Serbian Bankruptcy Law consists of provisions similar to the German and U.S. bankruptcy laws. It applies to all companies including listed companies and state-owned enterprises.[37] Insolvency of financial institutions is regulated by the Law on Bankruptcy and Liquidation of Banks and Insurance Undertakings.

100. Investment firms are subject to regular reporting to the authorities. Investment firms must submit to the SSC monthly reports with information on the turnover of financial instruments, revenues per license service provided, number of clients and securities financing transactions. In addition, broker-dealers must file monthly reports on liquidity, quarterly reports with information on assets and liabilities, and annual reports with audited financial statements, an audit report on internal controls, accounting procedures, risk management and clients' assets safeguards, and information on operations and qualified holdings. The SSC has a Market Participants Department and a Supervision Department, staffed with four and six persons respectively, to register and oversee 33 investment firms (21 broker-dealers and 12 banks), six investment fund management companies, 21 investment funds, six custodian banks, a securities exchange and an MTP (2018). The Supervision Department applies on-site and off-site supervision tools. A risk-based matrix is used to plan inspections. The SSC may administratively sanction a market participant with public censure, suspension of some or all activities and trading, and fines. It may also take economic violations and criminal offenses to the state authority responsible for investigating and prosecuting such cases. No fines have been imposed yet.

Accessing trading platforms and instrument pricing

101. Operation of a regulated market requires a license by the SSC for which the operator must be headquartered in Serbia. A broker-dealer company or a stock exchange may be authorized as an MTP operator. Licensing requirements include minimum capital requirements.[38] In the case of exchanges, initial and ongoing requirements, such as arrangements to identify and manage any conflicts of interest and all significant risks, arrangements for the sound management of the technical operation of systems, transparent and non-discretionary rules and procedures to ensure fair and orderly trading, and arrangements to facilitate the efficient and timely conclusion of transactions executed under its systems. Currently, the BELEX

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[37] Bankruptcy proceedings cannot be conducted against the Republic of Serbia, autonomous provinces and units of local self-government, the NBS, the CSD, public agencies, among others.

[38] EUR 1,000,000 for stock exchanges, EUR 730,000 for MTPs and EUR 1,000,000 for both.

operates the regulated market and the MTP. Only shares, sovereign bonds, EBRD bonds and municipality bonds are quoted.

102. The SSC approves the rules and procedures of exchanges, including fair access to systems and information, listing rules, market surveillance, and disciplinary and dispute resolution procedures. The exchange informs the SSC of admissions, rejections and removals from trading. Through its trading platform, BELEXFIX, the BELEX provides its members access to the real-time pre-trade information on current best bid and ask prices and the 10 level Best-Bid-Offers for the Prime Listing, Standard Listing, Smart Listing, Open Market and the MTP as well. It also gives access to the post-trade market data on the price, volume and time of the transactions executed in all financial instruments. The SSC may provide an exemption from transparency rules upon request by a market operator, based on the type or size of the transaction.

103. The SSC does not have direct access to trading systems, **but the exchange must submit reports on executed transactions.** This includes a daily report (quantity traded and closing price of each financial instrument), a monthly report (turnover of financial instruments, members' shares in turnover, revenues, admissions to trading, rejections of admission to trading and suspension of trading and removal from trading, supervision and any measures taken), a quarterly report (assets and liabilities of the exchange), and an annual report (annual financial statement and audit report).

104. Transactions executed in the regulated market or the MTP must be cleared and settled through the CSD. If a member fails a transaction, a mutual guarantee fund is used to conclude the transaction. All members must contribute EUR 40,000 to a clearing and settlement guarantee fund except for the Republic of Serbia and the NBS. If the guarantee fund is not sufficient, the CSD shall take emergency steps for enforced sale or enforced purchase of financial instruments. There is no monitoring of large exposures.

Pending issues

105. The SSC faces multiple challenges. One of the challenges consists in combining the alignment with the EU acquis and an increased complexity in market rules, with declining resources and a market that is still at a developing stage. New regulation should follow the direction of EU rules and be translated in a proportionate manner and provide additional guidance to market players in a way that is adequate to market developmental needs.

106. The focus should be to continue developing and implementing a risk-based supervisory framework. The SSC is encouraged to continue the switch to a risk-based approach where resources are oriented towards the supervision of major sources of risk. It will help the SSC maximize the impact of its supervision, especially given the scarcity of its supervisory resources. This approach implies developing a good reporting framework and risk indicators as well as a robust off-site surveillance process, which then allows for using on-site inspections in a more strategic and relevant manner.

107. *Capital of investment firms.* Current rules impose initial capital requirements. A risk-based approach to capital adequacy requirements applicable to firms providing investment services and in particular the service of dealing for its own account, could be usefully adopted to add to the overall framework robustness in case of a participant's failure.

108. ***Managing market systemic risk.*** Post the financial crisis, the focus of securities regulatory and supervisory authorities has evolved to also include financial stability. As an example, market regulators are now requested to monitor large exposures and such monitoring should be introduced for the identification and management of systemic risks. NBS and SSC should also have a clear process to identify and adequately manage any eventual systemic risks posed by market participants and market infrastructures.

109. ***Public Issuers Financial information.*** Investment firms submit annual financial statements and quarterly information on assets and liabilities. If not already done, the SSC is encouraged to adopt examination procedures of issuers' financial and non-financial information that go beyond a disclosure checklist and provide a critical look at the content of the disclosures to ensure that they are informative, provide useful information, and challenge them when information (for example assumptions used) is not reasonable. The number of qualified audit opinions is indicative of poor internal controls and willingness by issuers to apply the relevant financial reporting framework. This should be duly reacted upon.

110. ***Pricing data access and cross netting arrangements.*** Investors need easy and reliable access to security pricing, as currently offered by the exchange. They also need the possibility to unwind their positions at the right price, if they need to do so. On pricing, additional information on the reporting of transactions executed as dark or OTC would be useful. The authorities may also find it useful to inform the public on the recently adopted collateral management framework in order to clarify its scope and the operation of recognized and automatic contractual netting arrangements. Finally, and even if no local credit rating agency exists, access to a credit rating may allow institutional investors to have a better access and understanding of local companies, especially publicly traded ones.

111. ***Clearing and settlement*.** Enforcement of sales or purchases of financial instruments could be used first to deal with failed transactions, instead of using the guarantee fund, which then could be used to cover any price differences, strengthening risk management. In addition, the authorities may want to consider strengthening the requirements and controls applicable to investment firms holding client's assets and funds.

112. ***Authorities Communication.*** The SSC website is clear, and information is easily accessible, generally in English. Some additional information could be usefully published on-line, such as:

- The previous version of regulations with date of changes, so investors can keep track of all regulatory changes;
- Explanation of the regulatory consultation process, directly on the SSC website, together with an explanation of the regulatory structure of the existing framework with a link to the relevant official documents, collateral and asset protection mechanisms and corporate governance rules applicable to issuing entities; publication of funds NAVs, etc.;
- Explanation of the internal compliance structure of the SSC and availability of an ombudsman and mediation procedures for investors; and
- The SSC's ongoing work in terms of risk-based supervision, macro market risks taken into consideration in the commission supervisory program, and work undertaken with market participants to address existing concerns or emerging risks.

All these aspects are key to enhance investors' confidence and allow them to perform their due diligence.

Annex 1: Framework for Capital Markets Diagnostic

The World Bank, with support from authorities in the Western Balkans, is currently developing a practical guide for capital markets development in small economies. The guide aims to support policymakers and regulators of small economies in identifying general preconditions, key constraints and areas of potential for capital markets development. The Serbia assessment broadly followed the initial framework developed for the analysis of preconditions and capital markets development. At the same time lessons learned from applying the methodology to the Serbia context have been key to further shaping the framework and adapting it to the realities that small economies face. The chart below reflects the latest thinking on the assessment framework which forms an integral part of the practical guide. Publication of the guide is expected by mid-2019.