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FINANCIAL SERVICES VOLUNTEER CORPS, INC.

MISSION TO YUGOSLAVIA

December 14 - 20, 1990

OBSERVATIONS, FINDINGS AND RECOMMENDATIONS

December 31, 1990

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BACKGROUND AND SUMMARY

MISSION TO YUGOSLAVIA
DECEMBER 14 - 20, 1990

At the request of the Yugoslav Government, the Financial Services Volunteer Corps, Inc. (FSVC) conducted a Mission to Yugoslavia from December 14 - 20, 1990. The FSVC Mission was led by the Honorable Cyrus R. Vance, Presiding Partner, Simpson Thacher & Bartlett, former Secretary of State, and Co-Chairman of FSVC. Vice Chairman of the Mission was the Honorable Herbert S. Okun, Executive Director of FSVC and former U.S. Ambassador to the German Democratic Republic.

Background

FSVC is a program in conjunction with the Department of State/Agency for International Development designed to make available the experience of senior financial-sector professionals to the emerging democracies of Central and Eastern Europe who request assistance with their programs of conversion to market economies. It was created in response to President Bush's initiative to encourage volunteerism. FSVC is comprised of specialists from U.S. commercial and investment banks as well as law and accounting firms. They provide their services on a volunteer basis. Missions to Poland and Hungary were undertaken in May and September, 1990, respectively.

Steering Committee

The Honorable John C. Whitehead, Chairman, AEA Investors Inc., and former deputy Secretary of State, is Co-Chairman of the Board of Directors and Co-Chairman of the FSVC Steering Committee together with Mr. Vance. Other members of the Steering Committee are:

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Chairman, Strategic Planning
Committee
Johnson & Johnson

John J. Phelan, Jr.
Former Chairman
New York Stock Exchange

Lewis T. Preston
Chairman, Executive Committee
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The Honorable Paul A. Volcker
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Marina v. N. Whitman
Vice President and Group Executive
General Motors Corporation

Members of the Mission to Yugoslavia

Chairman: Cyrus R. Vance

Vice Chairman: Herbert S. Okun

Banking Team

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Administration

Robert J. Rourke
Director for International Development
Ernst & Young

Objectives

The principal objectives of the Mission to Yugoslavia were to provide advice and guidance on:

- Increasing the effectiveness of Yugoslavia's commercial banking system, including supervision;
- Strengthening the role of the banking system and capital markets in promoting the transition to a more market oriented economy, including the development of the various Yugoslav stock exchanges; and
- Promoting the privatization process.

The Commercial Banking Team advised on the role and function of the Central Bank and on the process of developing a sound commercial banking system, including bank regulation and supervision as well as interbank payments mechanics. The Capital Markets/Privatization Team counselled its counterparts on the establishment of orderly capital markets, the importance of standardized, broadly understood accounting practices, and on the principal elements of successful privatization programs.

Meetings

During their stay in Yugoslavia, Mr. Vance and FSVC Mission volunteers met with members of the Government and financial community, including: President Jovic; Prime Minister Markovic; Foreign Minister Loncar; Kiro Grigorov, Economic Advisor to the Prime Minister; Slobodan Milosevic, President of the Republic of Serbia; Franjo Tudjman, President of the Republic of Croatia; Josip Manolic, Prime Minister of The Republic of Croatia; Ante Cicin-Sain, Governor of the National Bank of Croatia; Marijan Hanzekovic, Finance Minister of Croatia; Vjekoslav Tomasic, Economic Advisor to the President of the Republic of Croatia; Janez Drnosvsek, Slovenian member of the Federal Presidency, former President; Dr. Joze Mencinger, Deputy Prime Minister for Economic Affairs of the Republic of Slovenia; Milica Ozbic, Governor of the National Bank of Slovenia; the

National Bank of Yugoslavia; representatives of the Social Accounting Service (SDK); the Yugoslav Banking and Finance Institute; the Yugoslav Bankers' Association; commercial banks; the Belgrade, Ljubljana, and Zagreb stock exchanges; other agencies and institutions in Belgrade, Ljubljana, and Zagreb; and the academic community.

Scope of Mission

The FSVC Mission to Yugoslavia included assessments of the banking sector and financial markets at the Federal level and in the Republics of Serbia, Croatia, and Slovenia. Many of the issues related to the conditions of the financial markets in Yugoslavia had been submitted to the delegation in advance of its arrival in Yugoslavia and were addressed either by the Banking Team or the Capital Markets Team or, in some instances by the entire delegation in a series of workshops conducted in Belgrade, Ljubljana and Zagreb. The workshop format encouraged discussion of the conditions affecting development of the financial sector and privatization efforts; it also afforded representatives of government and business an opportunity to react to the observations and recommendations of FSVC members on a firsthand basis.

Prior to the start of the Mission, members of the FSVC delegation were aware that an effort to address Yugoslav conditions at both the Federal and Republic levels was perhaps overly ambitious for a seven-day visit. It quickly became apparent, however, that impediments to financial market development and privatization in Yugoslavia are similar at the Federal and Republic levels and, moreover, require coordinated rather than separate solutions. While the remainder of this report is devoted to presenting detailed observations and providing specific recommendations for development of the banking sector, capital markets, and acceleration of privatization efforts, it is possible to summarize the principal conclusions of the Mission regarding these efforts.

Summary of Findings and Recommendations

Compared to Central and East European countries and other emerging economies, Yugoslavia was once the most advanced in terms of its potential to move expeditiously toward a market-oriented economy. It had free access to the West, and a relatively small private sector coexisted with public ownership. These and other circumstances enabled the country to develop some of the financial and managerial skills necessary to establish a market-oriented financial system. For the past several years, however, vested interests and, more recently, regional conflicts have impeded Yugoslavia's development of a national program for reform of financial and market structures.

Ideally, the reformation of the financial system should begin with a political consensus as to the need for reform and, in particular, with close coordination between the Federal government and the governments of the Republics in implementing such reforms. At present such a situation does not exist. The Mission was informed in virtually every meeting that the economic situation in Yugoslavia could not be addressed until political problems were resolved, particularly, regional/federal issues. The Mission does not wish to minimize the complexity of the political situation. However, the lack of such a consensus need not necessarily block the path to economic reform. The compelling economic benefits for all of a financially sound banking system and of a profit-driven private sector are a powerful enough incentive to drive the reform process forward and, in so doing, can facilitate political agreement as to its merits.

At the broadest level, Yugoslavia's principal challenges in developing a credible banking sector, an orderly capital market, and a meaningful privatization program may be summarized as follows.

Lack of confidence in the banking sector. The Yugoslav banking system is in serious financial difficulty. Insolvent, or financially distressed, socially-owned businesses own the banks and use the banks to fund their own operations. There is limited meaningful Central Bank supervision of the system. The interbank payment system is rudimentary at best and dysfunctional. Individual and business savers are increasingly reluctant to entrust their savings to the banking sector.

Building public confidence in the banking system is essential in order to encourage private savings, to develop a stable deposit base for the banking system, and to create the structural foundation for centralized management of monetary policy. On the international level, confidence is essential if the banking system and the Yugoslav economy are to attract foreign investment and if Yugoslav banks are to be well received as borrowers and counterparties in international financial markets. The Banking section details the specific steps that FSVC considers critical to the rehabilitation of the sector.

Rudimentary market for financial instruments. Although there are several stock exchanges, as a practical matter there is neither trading nor liquidity because there are no securities to trade or investors to invest. Given the systemwide lack of confidence in the banking sector, there is an understandable lack of investor enthusiasm for other Yugoslav financial instruments, whether government bonds or business equities. The Mission believes that certain specific measures, outlined in the Capital Markets and Privatization sections, must be undertaken to begin to develop the confidence of prospective investors in the integrity of the markets. To this end, immediate measures must be undertaken to develop reliable financial information concerning prospective issuers of securities.

<u>Privatization process faltering</u>. The privatization process is significantly complicated by jurisdictional issues between the Federal and Republic governments, lack of central direction (or at least coordination) of the process, entrenched and often politically-motivated managements, and the absence of profit-oriented discipline in the management of most businesses. If privatization is to achieve its goal of bringing market discipline into the operation of Yugoslav businesses, building public interest in share ownership, and of attracting new capital to industry, each of these problems must be systematically and forcefully addressed.

<u>Need for prompt reform</u>. Yugoslavia is competing for scarce foreign capital. If the leadership does not move quickly to reorient the nation's banking system, and to restructure moribund businesses on a profit-oriented basis, serious damage to the country's ability to attract foreign investment will result.

<u>Overview of recommendations</u>. As Mr. Vance stated, the purpose of the FSVC Mission to Yugoslavia was not merely to observe or criticize. The purpose was to help and this report was prepared in that spirit. Throughout the report we have made candid observations and specific recommendations. We have provided offers of assistance that we hope will be useful in reforming the banking system, in expediting and fulfilling the objectives of privatization efforts, and in expanding the scope of Yugoslavia's financial markets.

In the area of banking industry reform, FSVC is prepared to provide additional assistance in more precisely defining the appropriate role of the Central Bank in the national economy and in the banking sector, and in developing a systematic credit review process in restructured commercial banks. We would be prepared to provide further advice on strengthening the Central Bank's bank supervisory capabilities, and we could furnish various reports and manuals on bank supervision and examination to assist in the process of training bank supervisory professionals.

We would also be prepared to provide technical assistance on the mechanics of the Yugoslav payment system and developing a market for overnight interbank funding. We would hope to be able to arrange meetings or conversations between U.S. based professionals and their Yugoslav counterparts in such areas as interbank payment mechanics, bank examinations, and the commercial bank credit review process.

To facilitate the development of capital markets and to expedite the privatization process, we have offered to provide additional accounting literature related to international standards and to develop contacts between professional accounting bodies in the U.S. and in Yugoslavia. We have identified a clear need for financial and business consultants to assist in the restructuring of certain businesses. Working with other U.S. Government affiliated groups, we can assist in the delivery of such expertise. In the development of the capital markets, we are prepared to provide assistance in the training and development of capital markets and stock exchange professionals.

The FSVC Mission is prepared to further develop specific sections of this report and, if appropriate, to return to Yugoslavia to provide additional assistance in particular areas. We thank all of those individuals with whom we met for their time and insights. We look forward to the opportunity to discuss this report, its recommendations and offers of assistance with Yugoslavia's public officials and representatives of the commercial banks and businesses.

BANKING

I. INTRODUCTION

Members of the FSVC Banking Team met with the Economic Advisor to the Prime Minister, representatives of the Yugoslav Banking and Finance Institute, and Yugoslav Bankers' Association; with officials of the Slovenian Finance Ministry, National Bank of Slovenia, and Slovenian commercial banks; with officials of the Croatian Finance Ministry, National Bank of Croatia, and Croatian commercial banks; with representatives of banks headquartered in Serbia; with officials of the National Bank of Yugoslavia and of the Agency for Deposit Insurance and Bank Restructuring. The discussions were frank and illuminating, and FSVC deeply appreciates the warm reception it received from banking, enterprise and governmental officials throughout its seven-day visit to Yugoslavia.

The Team regards the establishment of broadly-based domestic and international confidence in market-oriented financial institutions in Yugoslavia as an objective of fundamental importance. This objective should guide the current efforts to restructure the Yugoslav banking system. Yugoslavia faces a critical juncture in its history, characterized simultaneously by remarkable opportunities and very real dangers.

On the domestic level, building public confidence in the Yugoslav banking system is essential if households are to entrust their savings to the nation's banks, and if the banks are to develop a deposit base that is not solely dependent on funds from the Yugoslav enterprise sector.[1] At a minimum, individuals must have confidence that they can readily withdraw their savings as necessary to meet their financial needs. On the international level, confidence is essential if the Yugoslav banking system and economy are to attract foreign investment and if Yugoslav banks are to be well received as borrowers and counterparties in international financial markets. Unless Yugoslav leaders promptly design and implement reform of the banking system, the nation's ability to attract foreign investment will be compromised.

The focus of reform must be on the banking system as a whole. If confidence in the system is lacking, no single commercial bank will be able to emerge as an "island of excellence," capable of establishing both a strong domestic deposit base and credibility in world financial markets. At the heart of the banking system's overall credibility is that of the Yugoslav Central Bank, and its role will be discussed in the section that immediately follows. The next section reviews steps that the Team believes should be taken to restructure and develop the commercial banking system more broadly. Throughout this discussion, it is important to keep in mind that these two subjects -- reaffirming the credibility of the central bank in a new, market-oriented context and restructuring the commercial

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1/ In Yugoslavia, the term "enterprise" is used to describe most businesses. Throughout this report, the terms "enterprise," "business," and "company" are used interchangeably.

banking system -- are closely intertwined and, indeed, dependent upon one another.

II. ROLE OF THE CENTRAL BANK

The Central Bank in Yugoslavia's market-oriented economy should house three broad functions. First among them is the conduct of monetary policy. The other two are the broad oversight of the financial system and participation in certain aspects of the payments system. A theme that unites all three of these functions is stability -- stability in the value of the currency and in the workings of the financial system, including the payments system. This single theme of stability reflects an interaction of all three functions, with each one mutually dependent on the others.

FSVC recommends that the National Bank of Yugoslavia (NBY) strive to build its capabilities with regard to these three central banking functions. While the subject of monetary policy was not a principal focus of the Team's work, we believe that the NBY should be empowered to strengthen its control over this function. Although the adjustment of reserve requirements is a standard means employed by Central Banks to adjust liquidity in a banking system, in Yugoslavia a separate governmental institution has possessed de facto authority to override reserve requirements for banks set by the NBY. This institution, the Social Accounting Service (SDK), reports to the Federal Parliament and is not accountable to the NBY. We recommend that the NBY be made solely responsible for setting and enforcing such reserve requirements.

A. Payments System Policy

In the area of payments system policy, the Team understands that the SDK also directs Yugoslavia's principal payments system, with minimal involvement of the NBY. The historic role of the SDK in the payments system has included monitoring funds transfers (as opposed to facilitating such transfers) and authorizing Yugoslav banks and enterprises to run overdrafts on that system, or to prohibit such overdrafts. While Yugoslavia's payments system has technically performed in a reasonably reliable way under SDK's oversight, the fees charged have been high and have been based on the face amount of transactions rather than SDK's marginal costs. In the view of some observers, the fees have been so high as to preclude development of an overnight interbank funding market in the country. The current interbank payment system is rudimentary at best and dysfunctional.

The Team believes that the NBY is the most appropriate institution to oversee the Yugoslav payments system and to promote its efficient operation. We therefore recommend that the NBY assume responsibility for supervising and/or administering the payments system at the earliest possible time. One means of encouraging this result would be for the SDK to transfer some or all of its payments system personnel to the NBY. If it were desired by Yugoslav authorities, FSVC would be prepared to facilitate the NBY's obtaining assistance in establishing a workable payments system.

The Team also recommends that the NBY seek to foster the development of an overnight interbank funding market in Yugoslavia. The existence of such a market would deepen liquidity in the banking system as banks with excess funds on a given day could on-lend them to other banks in need of short-term liquidity. This market would work most efficiently and would have the greatest depth if it were developed on a national basis. A nationwide market for overnight bank funds would have the further benefit of promoting interregional financial integration. FSVC would be pleased to be of assistance in this regard.

B. Bank Supervision

With regard to the Central Bank's oversight of the financial system, the NBY needs to develop a strong capability to supervise the full range of activities conducted by Yugoslav banks. The importance of this capability will grow as Yugoslavia's banks redirect their lending procedures and other business activities along profit-oriented lines. The Team recommends that the NBY's supervisory capability include the development of a nationwide corps of examiners trained to conduct on-site inspections of the records and procedures of Yugoslav banks. The NBY should also review and strengthen its supervisory standards for bank performance, including minimum requirements for capital, asset quality, liquidity and the experience and credentials of senior management. Furthermore, limits should be set on the size of loans to single borrowers, and on loans to bank shareholders (if permitted at all). With regard to capital, the NBY should endeavor to set requirements that conform to the risk-based standards recently established by the Bank for International Settlements (BIS). If immediate conformity is not possible, then the NBY should apply the BIS rules to internationally active banks headquartered in Yugoslavia at the earliest possible date.

As the NBY strengthens its capabilities to carry out its central bank functions, a guiding principle must be the preservation of its independence from political influence. The Team notes that many other countries facing challenging political circumstances have earned for themselves an important measure of financial stability by enforcing this principle. Moreover, this independence is <u>essential</u> if the NBY is to maintain the confidence of the international and domestic financial communities. The successful conduct of monetary policy, the efficient operation of the payments system, and the impartial and competent supervision of Yugoslavia's commercial banking sector all require such political independence.

FSVC is prepared to provide additional assistance in more precisely defining the appropriate role of the Central Bank in the national economy and the banking sector. We would be prepared to provide further assistance on strengthening the

Central Bank's bank supervisory capabilities, as well as technical assistance on the mechanics of modernizing the Yugoslav payment system and developing a market for overnight interbank funding.

III. <u>RESTRUCTURING AND STRENGTHENING THE COMMERCIAL BANKING SYSTEM</u>

Given the technical insolvency of most Yugoslav banks today, there is a critical need to carve out the bad loans that dominate the asset side of the banks' balance sheets and to replace those loans with higher quality assets such as government bonds. Concurrently, the banks need to be recapitalized. While this report will not attempt to evaluate the alternative methods (most of which were discussed over the course of the Mission) available to remove problem loans, or restructure the banks' balance sheets, several broad guidelines should nevertheless be noted.

First, as the Yugoslav government and the Agency for Deposit Insurance and Bank Restructuring go about selecting those banks to rehabilitate first, the great importance of creating some early and clear "success stories" should be kept in mind. Several banks that could be made to operate profitably and on the basis of a positive net worth should be chosen as candidates for prompt restructuring. The example of several successfully revitalized banks would help to build domestic and international confidence in the Yugoslav banking sector and would underscore the government's commitment to building a market-oriented and profit-driven financial system. For reasons already discussed, the Yugoslav government should move forward rapidly with a comprehensive program of bank restructuring, one that is capable of producing timely and visible success cases. Although Yugoslav officials did not disclaim the intention to proceed with such a program, the Team believes that the commitment to bank restructuring across the government is mixed. Further, we were given to understand that no agreement yet exists regarding the order in which banks possessing differing degrees of financial strength will be restructured. As the debate within the Yugoslav government of these policy questions continues unabated, time is being lost. Meanwhile, neither foreign nor domestic confidence in the banking sector is being strengthened, and foreign investors are generally continuing to look elsewhere for business opportunities.

Second, a key principle underlying the development of a market-oriented commercial banking system in Yugoslavia must be the fostering of an independent, unbiased credit process. Commercial banks must base decisions to lend funds on the creditworthiness of borrowers and not on other considerations, such as borrowers' equity stakes in the banks or governmental instructions. Only if funds are lent on this basis will credit reach the most deserving borrowers, i.e., those borrowers that can contribute most to the growth of the Yugoslav economy. Loans based on other criteria will weaken, and could ultimately destroy, the viability of the emerging banking system.

A. Rehabilitation Strategy

The principle of an independent and unbiased credit process carries direct implications for the ownership of Yugoslav banks. Banks that remain owned by commercial and industrial enterprises will almost certainly experience pressure at one time or another to extend loans to those owners, and such pressure may prove impossible to resist. The situation, in effect, would be similar to that found in the Yugoslav banking sector today, where the banks have been forced to extend large amounts of credit -- in reality, grants -- to the enterprises that own them. Given the lack of an arm's-length relationship between bank and borrower, and the absence of independent judgments on creditworthiness as the basis of lending decisions, it is not surprising that many of these banks are now technically bankrupt.

B. Bank Ownership

In our opinion, enterprise ownership of the banks should be terminated. The ownership structure of the Yugoslav commercial banks must not interfere with the promotion of a strong, independent credit decision-making process within the banks. Widely-held private ownership of the banks, combined with strict rules and limitations governing the extension of credit to shareholders, would seem to offer the most feasible alternative.

Still, other ownership structures are possible. For instance, governmental ownership of banks has been used occasionally in Western industrial countries and developing economies, and some official involvement in the ownership of Yugoslavia's banks may be necessary, at least for an interim period. If Yugoslavia chooses this option, the Team would urge that rules be adopted to restrict governmental involvement in the management of the banks, and particularly in the banks' credit decisions.

C. Banking Issues

Yugoslav officials face a myriad of other complex issues as they confront the challenge of redirecting their banking sector. Among the most important are the following:

- **Whether to authorize broad product powers for banks or instead to require banks to specialize in a limited range of financial activities.** While a number of different product structures for banks have been utilized in Western industrial countries, the Team recommends that Yugoslavia grant commercial banks broad powers of the nature authorized in the EC's Second Banking Directive. Even though a universal banking structure along German or Swiss lines is not employed in the United States, the practical distinction between commercial and investment banking in the U.S. is becoming increasingly blurred, as is the distinction between a commercial loan and a security. Relatively broad product powers would enable Yugoslav banks to develop more diversified earnings bases and to provide a more comprehensive range of services to customers. The approach would also be consistent with the banking framework currently being adopted by the EC. Also, the approach would not preclude banks from specializing in a more limited set of products -- from developing product "niches" -- if they chose to do so.

- **Whether to authorize formation of small banks or to limit participation in the banking sector to large banks.** In this regard, the Team recommends that banks of all sizes be encouraged. Banks of a variety of sizes are most likely to provide the broadest range of services on the most competitive terms. In addition, small banks can grow into larger banks in a robust, market-oriented financial system. The Team also recommends that the NBY continue to require new banks to hold some minimum absolute amount of capital; a requirement of $3 million would probably suffice, which is somewhat less than currently required.
- **Whether to place geographic restrictions on banks or to permit them to operate nationwide.** The Team recommends that banks licensed by the NBY to do business in Yugoslavia be allowed to operate throughout the country. National business bases would help the banks develop more diversified and stable income streams and should also enable the larger banks in the system to be more competitive internationally. A further important benefit would be to promote the creation

of a national banking market in Yugoslavia and hence to help integrate the country economically. Nationwide banking should also facilitate delivery of up-to-date banking products and services to less developed parts of the country.

Whether to permit foreign branches to operate in Yugoslavia and whether they should be permitted the same degree of freedom as domestic banks. Foreign banks could be a stimulative, competitive force in the Yugoslav banking system, introducing new ideas and new financial techniques that would benefit the economy as a whole. Not only households and private enterprises but also indigenous Yugoslav banks should derive advantages from the active presence of foreign banks in the banking system. The Team notes that American financial markets have been made more innovative and resilient by a policy of "national treatment" under which foreign banks are permitted to engage in the full range of activities in the United States that U.S. banks are authorized to pursue. Particularly at a time when Yugoslav banks are seeking to strengthen their credit and other financial and administrative procedures, foreign banks operating in the country could serve as constructive examples and partners.

Given the relative sophistication and financial strength of many foreign banks, however, it may be advisable for Yugoslav officials to consider placing some restrictions on their operations within Yugoslavia for a brief initial period. This would give indigenous banks the time to develop financial strength of their own and market share in the newly restructured banking sector, while benefiting from the competitive stimulus and role-model value that foreign banks would be bringing to that sector. Joint venture structures, in particular, would encourage foreign banks to contribute to the development of financial and administrative skills in local banks. Any initial restrictions on the activities of foreign banks should not be so extensive as to destroy their ability to operate profitably; otherwise, foreign banks will fail to provide any positive example whatever to indigenous banks and will eventually depart.

Accounting issues. The Team regards the adoption by Yugoslav banks of internationally-accepted accounting standards as a prerequisite to their achievement of international credibility. Such standards must govern the banks' approach to recording the value of the assets on their balance sheets and to reporting income. A more detailed discussion of accounting issues appears later in this report.

The development of bank deposit insurance and a social safety net. The Team urges the Agency for Deposit Insurance and Bank Restructuring to move forward as promptly as possible with its plan to insure household deposits of up to $10,000 in Yugoslav banks, and to charge banks a periodic assessment to cover the cost of the insurance. In this regard, discussions with officials of the U.S. Federal Deposit Insurance Corporation would almost certainly prove helpful, particularly on technical aspects of deposit insurance such as calculating the appropriate level of premiums.

The Yugoslav government should also establish an effective program of unemployment compensation if the overall restructuring of the banking sector and economy are to succeed. A consequence of establishing a profit-motivated economy is that banks and companies which do not provide goods or services accepted by the market simply go out of business. As workers in these companies lose their jobs, the Yugoslav government must be prepared to extend financial assistance and possibly other unemployment support to them for the period of time that they require to find new jobs in profitable, creditworthy companies.

Setting priorities. The Yugoslav government must take numerous steps in order to restructure and strengthen the banking and financial system. While some of these steps can and should be taken simultaneously, others would more appropriately be pursued in sequence in light of manpower, capital, and other resource constraints. Because of the importance of building public confidence in the Yugoslav banking sector, the Team believes that the need to build the credibility of the institution at its core -- the National Bank of Yugoslavia -- should receive the highest priority.

Toward this end, the political independence of the NBY should be reaffirmed as quickly as possible, along with its commitment to carrying out the three broad central banking functions discussed earlier. In addition, the creation of "success stories" in the restructuring of individual Yugoslav banks should receive nearly as high a priority. The development of Yugoslavia's capital markets can only be accomplished, in the Team's view, once the Central Bank has been strengthened and confidence in a restructured banking sector has been established.

CAPITAL MARKETS AND PRIVATIZATION

I. INTRODUCTION

The Capital Markets and Privatization Team met with representatives of the Federal government responsible for the development of capital markets and privatization, as well as representatives of the Republics of Serbia, Croatia and Slovenia. The discussions also included representatives from the Social Accounting Service (SDK), members of the academic community, individuals from businesses which will be affected by privatization, and representatives of each of the Belgrade, Zagreb and Ljubljana stock exchanges. Without the degree of central planning present in some other Central and East European countries, market forces in Yugoslavia have been given greater freedom to act in pricing goods and services. Yugoslav citizens, as well as capital, have been allowed to move freely across the country's borders and as a result are generally aware of market-oriented practices and principles. However, a combination of factors, including political, regional and ethnic tensions throughout the country, threaten to undermine Yugoslavia's headstart toward the evolution of a truly market-oriented economic system.

II. CAPITAL MARKETS

There is only the most rudimentary market for financial instruments in Yugoslavia. Stock exchanges have been set up in three of the Republic capitals: Belgrade (Serbia), Zagreb (Croatia), and Ljubljana (Slovenia). To date, the instruments traded on such markets are certain government securities, bank deposits, and a handful of equity issues of small businesses. There is virtually no liquidity on these exchanges. Nevertheless, with the establishment of the various stock exchanges and the outline of a regulatory framework, Yugoslavia has begun to lay the structural foundation for the development of a capital market. In the implementation of that structure we stress the importance of taking the necessary steps to develop investor confidence in the integrity of the markets. To this end, market participants, the exchanges, banks and broker/dealers must be highly credible, and immediate steps must be taken to develop reliable financial information on prospective issuers of securities. In order to foster the development of these markets in a systematic way, Yugoslavia must address certain threshold issues.

Investor Confidence. Most important is the development of investor confidence, the essential underpinning of any successful capital market. The primary and secondary markets must be perceived to be fair to all participants, individual and institutional, domestic and foreign. A positive public image of Yugoslavia's capital markets will be critical to the reformation of the banking system, to the implementation of any privatization program, and to the ability of company managements and employees to measure and realize value for their ownership stakes.

Accounting. Adoption of internationally-accepted accounting principles and auditing standards is fundamental to the establishment of a capital market in which market participants (investors, domestic and foreign, as well as issuers and dealers) will have confidence in the quality, reliability, and comparability of financial information. We recommend that Yugoslavia announce promptly its intention to adopt such principles and standards and that they be made applicable upon adoption by those companies in the process of privatization. The Team stresses the importance of adopting a consistent set of accounting principles and developing the necessary professional infrastructure. In Appendix I we have outlined suggestions for the development of an accounting practice, and identified specific areas where FSVC and other organizations might be of assistance.

Securities Law. A comprehensive, modern securities law is fundamental to a capital market because it provides a legal framework designed to promote fairness and investor confidence. The specific principles of such a legal framework are detailed in Appendix II.

Creation of a Financial Sector. The evolution of the capital markets must be supplemented by the creation of a framework for the development of an institutional market. To the best of our knowledge, there is no concept of private or public pension funds, mutual funds, or other pooled investment vehicl[illegible] in Yugoslavia. Nor is there a well defined concept of financial intermediaries, such as securities brokers and dealers. To date, the only capital markets participants are the government and, to a very limited extent, the banks. Insurance companies make their own direct investments in real property and in bank deposits. Pensions are funded by Federal authorities and by businesses out of current taxes and earnings, not from funds earned through contributions over time. Private savings are limited, and to the extent they exist, are kept at home, offshore, or at banks, often in foreign currency deposits.

A rehabilitated commercial banking sector must play an important role in the capital markets by making markets in government instruments, bank deposits and acceptances, and foreign exchange. In addition, as the market for equity securities develops, securities brokers and dealers should be created to facilitate the distribution and trading of financial instruments. Consistent with broadening the product powers of the commercial banks, we would encourage bank participation in securities market activity.

While the development of methods to encourage private individual savings and of structures to fund and manage public and private pension assets was beyond the scope of the Team, the need to begin educating the public as to capital markets generally, and to begin to train investment professionals, is evident. We are prepared to provide copies of training materials for securities brokers, including books and films. In addition, consideration should be given to the implementation of a pilot internship program for senior government, bank, company and exchange officials involved in the capital markets or investing process. Such a program could be sponsored by securities firms and banks in the United States and Europe who would take on a small number of Yugoslav professionals for one to three month internships designed to broaden their understanding of developed capital markets and of the investing process.

Tax Regime. Growth of the capital markets might also be stimulated through careful management of taxation policies. A comprehensive review should be made of all taxes and similar charges that are to be applicable to participants, both domestic and foreign, in Yugoslavia's capital market. The taxation, if any, of interest and dividends, as well as of capital gains and losses, should be rationalized in light of all policy considerations. Obviously, the lower the tax burden, the more attractive will be the Yugoslav capital market to businesses in need of capital, and to individuals and institutions with money to invest. A tax policy specific to Yugoslavia should be developed through discourse with the financial, investor and governmental communities. Investor interest in the capital markets will be stimulated through tax incentives and through the consistent and fair application of tax policy.

III. PRIVATIZATION

Yugoslavia has a variety of objectives in undertaking the privatization process. These include, among others:

- Attracting new capital to the commercial sector, primarily from external sources;
- Improving the efficiency of business;
- Contributing to the growth of the capital markets;
- Raising capital to finance social programs; and
- Providing workers and individuals the opportunity to directly own shares.

If any of these objectives is to be fulfilled, the Government must promptly transform "social ownership" into a more specific definition of business ownership rights.[2] In addition, privatization must be accompanied by significant corporate restructurings.

Enterprise Restructuring. Two organizational aspects of Yugoslav industry must be noted. First, as has been discussed, the banks are owned and controlled by the

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[2] Under Marshall Tito, Yugoslavia adopted a system of "social ownership." Socially-owned "enterprises" were endowed with social capital (plant and equipment) and were controlled by workers' councils. These councils selected management and made business decisions. At least in theory, workers controlled the companies and "society" owned the assets. There was neither state ownership of business nor worker ownership. Specification of ownership rights is a necessary precondition to privatization. While the Federal Government has passed legislation that attempts to clarify ownership rights, at least two republics appear to have rejected the Federal law and are in the process of developing their own, adding a further layer of complexity to an already conceptually and technically difficult issue.

"enterprises." Second, the enterprises often act as surrogates for the state in providing housing, jobs, unemployment and retirement benefits to all employees.

We repeat here our recommendation that enterprise ownership of the banks should be severed. Not only is such separation a prerequisite to the rehabilitation of the commercial banking sector; it is also essential to the restructuring of businesses on a profitable basis, to the management of the private sector under the discipline of the financial markets, and to attracting fresh capital into enterprises through privatization.

A consistent concern expressed in our discussions with Government, banking and business officials was the reluctance of enterprises and workers to support enterprise restructuring given the absence of a "social safety net." However, given the number of insolvent companies and the large numbers of substantively unemployed workers, it is important that the government enhance the existing social benefits (such as unemployment, retraining, and retirement benefits) to facilitate the transition to market-oriented, privately-owned businesses. As is the case with the banks, if enterprises are forced to bear the burden of providing all social services by continuing to carry excess workers, few will be sufficiently profitable to attract capital from the highly competitive and selective international capital markets.

Privatization Legislation. Over the past twelve months, various pieces of Federal privatization legislation have been passed that attempt to address the ownership question and provide for privatization. For the first time since World War II, new companies may be funded with private capital and controlled by the providers of that capital, not by workers, management or society. In addition, a mechanism has been created whereby "socially-owned" enterprises can be partially transformed into private businesses by permitting workers to own shares and by permitting the sale of new shares (and other instruments) to private providers of capital. Workers may be offered shares at discounted valuations, and proceeds from share sales will accrue to a Federal Development Fund, which will be used to fund social programs. Under the Federal law, the implementation of the privatization process is left to newly-created agencies in each Republic. Significantly, under the legislation, privatization is not mandatory, but is left to the individual enterprise managements and workers. It is the responsibility of the Federal and Republic authorities to implement specific privatization procedures for individual businesses.

The Federal legislation is an important step in the privatization process and represents a commendable effort at defining a path from social to private ownership. There are, however, several weaknesses in the legislative framework for privatization. The purely voluntary nature of the program and the lack of clear, near-term incentives for workers to support privatization may undermine the overall privatization effort. Moreover, the apparent absence of Federal efforts to identify those companies best suited for privatization based on size, prospective performance characteristics and need for new sources of capital may lead to some early privatization failures. Early failures may in turn adversely affect the probabilities of success of subsequent efforts. Within the context of the existing legislation, we strongly encourage the Federal and Republic governments and the various privatization agencies systematically to identify and prioritize candidates for privatization, and to develop laws or incentives for such entities to proceed with privatization.

Following are specific aspects of privatization that policy makers should consider in order to expedite and achieve the objectives of the privatization process.

Role of Government. One common characteristic of successful privatization initiatives is that the government clearly, forcefully and promptly identify the primary government bodies with oversight responsibility for program implementation. In Yugoslavia, there are both Federal bodies and agencies of the Republics involved in this process. There must be a clear delineation between Federal and Republic responsibilities and authority, and proper coordination between the two. If outside investors are to be encouraged to devote the financial and personnel resources to consideration of investment options in

Yugoslavia, the governmental decision process must be well defined and responsive.

Preparation. The Team was informed by a number of its interlocutors that many poorly performing businesses were being considered for privatization, not the more profitable ones. We find this disturbing. If privatization is to succeed in achieving any of its objectives -- principally those of creating value for business owners and society and in attracting new capital -- starting with the "loss leaders" is the wrong approach. Every effort should be made to create successful privatization models at the earliest possible date. If privatization is to be successful, it must begin with the better businesses, or, as discussed previously, with restructured businesses. Only if successful examples of privatization are developed will the process continue and its longer-term objectives be accomplished. Our recommendation in this regard parallels the one that we made in respect of the banking system.

In order to maximize the results of each privatization, it is essential that the targeted enterprises be properly prepared in advance of privatization. There are a number of steps which should be taken immediately. The wide range of companies that are eligible for privatization should be reviewed and rationalized. Given the many hundreds of businesses that may be privatized, there will be some that, if combined with others or broadly reorganized, would produce more attractive results from the perspective of proceeds realized from their initial sale and from their ongoing business operations.

There appears to be a significant need, at the level of individual businesses, for the assistance of management consultants and financial experts in the process of enterprise restructuring. If requested by Federal authorities, FSVC would be pleased to assist in the identification of such expertise and its application to appropriately targeted businesses.

Valuation. The Team was asked repeatedly for assistance in the process of valuing enterprises. Valuation is important for purposes of setting privatization priorities, allocating scarce Federal, Republic and outside advisory resources to the process, and in devising equitable worker/management share purchase plans. The complexities of enterprise valuation should not, however, preclude progress on privatization prioritization, enterprise restructuring, the development of accounting standards and other matters. For businesses in which shares may be sold to a single strategic investor or broadly distributed and sold to the public, valuation will be determined by negotiation between the parties and by market conditions at the time, not by theoretical or academic models. To this end we are prepared to provide the Government with additional assistance in understanding public and private market valuation methodologies and in valuing specific businesses, if requested.

Management. Management must be evaluated when considering the viability of a business and changes made where appropriate. Privatization can be a catalyst for management improvement and change. The Federal Government and agencies of the Republics, working with businesses, should strongly encourage, if not mandate, management changes where required. It is important that such changes be based on managerial experience and substantive expertise, not political affiliation.

The privatization authorities should consider various forms of incentive programs for management and other employees which are tied to the performance of the companies for which they work. We are prepared to make arrangements to provide information on how worker ownership and share purchase plans have been integrated into other successful privatizations.

Foreign Ownership. We believe that active participation by the international investment community is essential to the success of the privatization program.

The sale of strategic stakes in certain businesses to non-Yugoslav investors, with a significant interest in the company retained by employees or the state, should be encouraged as an element of privatization. Permitting such investments provides time to get the particular business operating on a profitable basis. Outside expertise provided by the investor can expedite the return to profitability of the enterprise. The retention by employees, or by the state, of some substantial stake enables all of the owners, including employees, to participate in the enhancement of share value over time. There is, however, a _quid pro quo_ to this approach. The foreign strategic investor must be given a measure of control over the enterprise commensurate with the investor's economic interest, and the resultant flexibility to operate the business on a profit-oriented basis.

Summary. We commend the effort of the government to enact and implement a meaningful privatization program. However, given the difficulties inherent in any privatization process and the uniquely decentralized nature of its political system, Yugoslavia faces significant challenges in carrying out a successful privatization program. In the judgment of the Team, the steps outlined above are necessary to encourage management and worker participation, to attract outside capital into the system, and to create economic value for the country.

Proposal for the Adoption of Standardized Accounting Principles and the Development of an Accounting Profession

Code of Accounting Principles. The existing code of Yugoslav accounting principles is under revision. An objective of this revision is to develop principles and methodologies that are consistent with International Accounting Standards (the "Standards"). This is fundamental to establishing a capital market in which market participants (investors, domestic and foreign, as well as issuers and dealers) will have confidence in the quality, reliability and comparability of financial information. We encourage the early adoption of International Standards through the revised code, together with a declaration that the code has to be applied by enterprises involved with privatization.

We note that the revised code of principles need not consist solely of the International Standards. These Standards do not address all areas of accounting, and for those areas that are addressed, the Standards merely provide a framework outlining acceptable alternate treatments. It is therefore possible to comply with the Standards and yet develop a code of accounting principles and methods which is more specific to the needs of Yugoslavia, as is the case in the United States and many of the world's developed economies.

Particular emphasis in the code should be given to the development of standard financial statement formats and groupings, such as those found in the European Community Directives or in Securities and Exchange Commission (SEC) regulations in the United States. It is also important to include as a requirement the concept of asset valuation (historical or revised cost), market and recoverable asset values, and the appropriate method of reporting value within an inflationary economy.

After adoption, it is important that the revised code be consistently applied, particularly by those enterprises involved with privatization. There should be a uniform application between Republics and businesses and between accounting periods. This will provide the investment community with a base of knowledge from which they can make comparative assessments and therefore develop market values for businesses throughout Yugoslavia.

To assist in the development of the revised code, we would be pleased to submit examples of accounting standards and practice adopted in the United States and the European Community, together with examples of financial statement disclosure practice.

National Association of Accountants. One method of developing the consistent application of Yugoslav accounting practices would be to develop and strengthen a national body of professional accountants. Such a body would be consistent with those found in the United States (the American Institute of Certified Public Accountants, AICPA) and throughout the world, for example, the Institute of Chartered Accountants in England and Wales, ICAEW. The Yugoslav organization could be empowered to:

- Develop and maintain accounting and auditing standards;
- Regulate admittance to the audit and accounting professions;
- Discipline existing practitioners to maintain quality control standards; and
- Influence the development of minimum training standards for all levels of the profession.

The organization should provide a forum for all members of the accounting community to develop consistent practices. It should, therefore, be managed by a board consisting of members of government, the academic community, professional audit and accounting firms, and accounting practitioners within businesses. It should be given credibility through power of regulatory enforcement -- for example, the ability to void an audit or to prevent a business from entering the capital markets. To assist the development of a national Yugoslav organization, we would be pleased to arrange a dialogue with the AICPA in the United States so that it can share experiences of development, organization and operations with its Yugoslav counterparts.

Education. To ensure consistent application of the revised accounting principles, it will be necessary to train all levels of the profession, particularly accountants at the enterprises. We understand that elements of the accounting community, such as the Association of Yugoslav Accountants, are currently facilitating this process by providing seminars upon request. The seminars should not only address the revised code of accounting principles, but should also educate attendees as to the necessary quality and quantity of financial data which will be required from businesses following privatization and eventual admission to the capital markets. Without sufficient training at all levels of the accounting community, it will be difficult to promote and enforce the necessary changes, for example, moving away from financial statements which are simply a compilation of statistics to ones which are meaningful to the investor community.

We will be pleased to assist this education process by providing examples of:

- International accounting methodology, for example, how to prepare and present intelligible financial data in a hyperinflationary economy; and
- Financial statement disclosure requirements in the United States, for both public and private entities.

It may also be possible to afford exposure by Yugoslav accounting professionals to the U.S. financial community through a training program with certain of the international accounting firms to meet specific objectives.

Audit. Creditable independent accountants will likely have to audit the financial statements of privatized enterprises to verify their reliability. While we were unable to study the complete readiness of the accounting profession in Yugoslavia to meet this challenge, it would appear that there is a significant need for training. It is likely that, at least during the transition period, the major international accounting firms will help fulfill this need through their contacts with the Yugoslav accounting community, such as the SDK and the academic institutes. The desired objective would be for Yugoslav accountants to become familiar with internationally-accepted auditing standards so that the Yugoslav profession can gain international prominence and recognition.

We will be pleased to promote this education process through our contacts with the major accounting firms and through our provision of examples of United States auditing standards.

General Principles of a Securities Law

General

As all countries with effective capital markets have recognized, the applicable framework and basic rules for the market must be set forth in an appropriate securities law. The key concern as to any such law is striking the proper balance between encouragement of creativity and enterprise, on the one hand, and on the enforcement of standards of responsibility, on the other hand, i.e., between under-regulation and over-regulation.

In this respect, other countries' experience teaches several important lessons, including:

> In the absence of required minimum standards of conduct and related penalties (and even in the face of such elements), certain market participants will act improperly;
>
> There are benefits to be derived from including in the law not only those provisions that seem absolutely necessary in light of immediate concerns, but also provisions that, on the basis of experience elsewhere, seem likely to be needed. This comprehensive approach also helps avoid having to return to the legislative body frequently for additional securities legislation.

Key Elements of Securities Law

(a) Securities Commission. The establishment of a securities commission is an important step in the development of a securities market. This commission should be an independent body composed of members with fixed terms and a staff of experts. It should have broad authority to adapt to changing circumstances by issuing and modifying regulations.

(b) Licensing. The law or commission should provide for the licensing of dealers and investment advisors, and of their individual managers and employees.

(c) Self-Regulatory Organization. A self-regulatory organization of dealers and other market participants should eventually participate in the regulatory process. The law should provide for this additional element.

(d) Disclosure.

(i) Provisions governing both prospectuses for direct ("primary") offerings by companies (and probably their controlling stockholders) as well as periodic (annual and interim) reports by companies to their stockholders and the investing public. We recommend that the role of the securities commission in reviewing prospectuses be only to assure that the disclosure complies with the applicable requirements; the commission should not have the additional power of prohibiting offerings because it disapproves of some aspect of the issuer or offering terms (a power that exists only in a distinct minority of jurisdictions).

(ii) A subject with important disclosure aspects is the status of governmental issuers. A decision should be made as to whether the national government will guarantee the securities of such issuers or will limit issues by such issuers only to those certain to be repaid, or whether such issuers will retain the same freedom to sell their securities as private companies will enjoy. In the latter situation, we believe that such issuers should be subject to the same disclosure obligations as private issuers.

(e) Collective Investment Undertakings. We expect that in Yugoslavia, as in all other major countries, a significant portion of investment by individuals will be made through collective investment vehicles (known in the U.S. as "mutual funds") -- that is, pools of investor-supplied money invested by professional investment advisors, offering the investor participants the right to purchase and redeem shares on a daily, weekly or other frequent basis. The securities law should include basic principles governing such entities.

(f) Temporary Prohibitions. We recommend that the law include temporary prohibitions on certain sophisticated types of securities and transactions - e.g., securities-related futures, publicly traded options and short sales. Prior to removing these temporary prohibitions, the securities commission should satisfy itself that such sophisticated securities and transactions are not likely to undermine investor confidence.

(g) Permanent Prohibitions. The law should contain broad prohibitions against trading practices that have come to be universally recognized as inconsistent with fair securities markets, e.g., "insider trading" (transactions in securities based on the unfair use of important non-public information) and "market manipulation" (artificial securities transactions designed to create a false public impression of the current market for a security).

(h) Securities Related Credit. The law should authorize the securities commission or another authority to control securities-related credit as a means of limiting excessive speculation. In this regard, FSVC would be pleased to put the appropriate Yugoslav officials in touch with their counterparts at the U.S. Securities and Exchange Commission (SEC).