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REPORT
BASEL II AND BANKING SUPERVISION IN BIH

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REPORT
BASEL II AND BANKING SUPERVISION IN BIH

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ABBREVIATIONS & ACRONYMS

BCPs	Basel Core Principles (for Banking Supervision)
BiH	Bosnia-Herzegovina
BIS	Bank for International Settlements
BLSE	Banja Luka Stock Exchange
CARDS	Community Assistance for Reconstruction, Development and Stabilization (EU)
CBBH	Central Bank of Bosnia-Herzegovina
CEBS	Committee of European Banking Supervisors
EU	European Union
FBA	Federation Banking Agency
FBiH	Federation of Bosnia-Herzegovina
FSAP	Financial Sector Assessment Program
FSC	Federation Securities Commission
FSSA	Financial Sector Stability Assessment
IAS	International Accounting Standards
IFRS	International Financial Reporting Standards
IMF	International Monetary Fund
IOSCO	International Organization of Securities Commissions
IRB	Internal Ratings-Based
MCOs	Micro-credit Organizations
MoU	Memorandum of Understanding
PARE	Partnership for Advancing Reforms in the Economy
RSBA	Republika Srpska Banking Agency
RSSC	Republika Srpska Securities Commission
SASE	Sarajevo Stock Exchange
USAID	United States Agency for International Development

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EXECUTIVE SUMMARY

Assessment of Compliance with the Basel Core Principles

Based on the FSSA/FSAP carried out by the IMF and World Bank in 2006, the two banking supervisory agencies and banking systems had similar areas of compliance, partial compliance or material non-compliance with BCPs. From the areas of material non-compliance, the major actions recommended for improvement in 2006 included:

- CP #1: Strengthening independence of the agencies and legal protection of supervisors, and specifically in the case of the RSBA, the provision of adequate resources and faster approvals of staff appointments to strengthen capacity and independence.
- CP#1: Improving information sharing, both domestically (Securities Commissions) and via Memoranda of Understanding with foreign supervisors, particularly countries of foreign bank origin.
- CP #6: Determining regulatory capital on a more risk-adjusted basis to account for market, country, transfer and operational risks.
- CP #7: Issuing more precise guidelines and increasing capacity to monitor market, operational and other risks.
- CP #8: Strengthening capacity to identify/monitor credit risk by validating bank systems' provision of reliable data/information.
- CP #9: Improving loan loss provisioning standards by issuing more precise guidelines and building up reserves for currency-indexed loans.
- CP #10: Analyzing large exposures on a consolidated basis and strengthening capacity to validate collateral valuation.
- CP #11: Analyzing related-party exposures on a consolidated basis.
- CP #12: Addressing the need for country and transfer risk guidelines.
- CP #13: Introducing capital charges for market risks, particularly foreign exchange-related risks, and enhancing capacity to monitor/contain these risks.
- CP #15: Issuing guidelines to better manage operational risk.
- CP #16: Issuing guidelines to better manage interest rate risk.
- CP #17: Issuing guidelines to banks' internal audit and control departments to better manage interest rate, operational and systems risk.
- CP #20: Strengthening supervisory techniques via on-site supervision and off-site surveillance by strengthening capacity to validate banking information and assess market and other risks.
- CP #21: Strengthening supervisory reporting by analyzing reports on a consolidated (as well as solo) basis, validating banking information, clarifying auditor qualifications, and having the power to revoke auditor licenses.
- CP #22: Strengthening accounting and disclosure by implementing IAS and qualifying auditors.
- CP #23: Improving corrective action tools by allowing the agencies to levy more costly fines on banks for violations.
- CP #24: Moving to consolidated supervision by analyzing risks of the non-financial activities of banks' operations.
- CP #25: Improving cooperation with foreign supervisors via MoUs and enhanced

information exchange.

A number of steps have been taken by both supervisory agencies to improve compliance with the BCPs. However, considerable challenges remain as of mid-2008. According to the two supervisory agencies, key challenges and risks include:

- CP #1: Legal protection for supervisors needs to be strengthened in RS, while the appointment process could be strengthened in the Federation.
- CP #6: Capacity to monitor and manage interest rate and (re-)pricing risk as a part of larger market risk has to be further developed. Particular emphasis on exchange rate risk is required.
- CP #7: Banks' internal audit functions sometimes need to operate more independently. External audit firms do not always meet international standards, although problem firms are generally excluded from conducting bank audits.
- CP #8: Banks need to fully comply with revised loan classification and loan-loss provisioning requirements once they are finalized.
- CP #11: A clearer framework regarding country and transfer risk will need to be developed.
- CP #12: A clearer framework regarding securities and derivatives trading will need to be developed, with particular focus on how volatility can impact bank balance sheets, earnings, and liquidity and risk management.
- CP #13: Greater capacity may need to be put in place to protect against the incidence of and losses from money laundering and the financing of terrorism, although findings from assessments suggest the banks are doing a reasonable job monitoring suspicious transactions.
- CP #14: Banks' internal audit functions will need more capacity, as do some external audit firms.
- CP #18 and #20: Banks will need to prepare and provide consolidated financial statements to the supervisory agencies, which they currently do not do.
- CP #23-25: Enhanced information exchange and coordination with other supervisory agencies to monitor cross-border exposures and risks will be needed.

In terms of the major preconditions for effective banking supervision, both entities continue to face ongoing challenges that are macroeconomic, infrastructure-related and institutional in nature. In many cases, these represent ongoing structural weaknesses in the legal environment and the real sector that continue to pose risks to banking stability, and require ongoing monitoring by the agencies and the banks for the detection and management of risk. Key challenges that are specific to banking supervision include:

Macroeconomic:

- Better coordination of cross-border issues and their potential impact on BiH as the banking system is dominated by foreign Europe-based banks. Current attention should be paid to rapid credit growth, partly funded by remittances, as well as the growing current account deficit. Future potential risks such as speculative bubbles will also need attention, particularly as they relate to residential and commercial real estate. Greater capacity at the supervisory agencies is needed with regard to larger financial stability issues. Cooperation needs to be strengthened with "home supervisors".

Infrastructure:

- Better consumer protection legislation that specifies rights and responsibilities of all parties involved in transactions is needed to bolster public confidence and build on the gains made since the 1990s, largely due to the growing effectiveness of banking supervision over the years.
- Capacity for effective supervision of non-bank financial institutions may need strengthening, particularly in insurance, capital markets and leasing.
- Judges and other personnel in the legal system would benefit from a better understanding of the fundamental operations of banking supervision. The economy and banks would broadly benefit from judicial capacity enhancement in commercial matters, including secured transactions, foreclosure, contract enforcement and dispute resolution.
- Appraisers of assets do not always have the professional skills or integrity to produce accurate valuations.
- Increased harmonization of regulations with international accounting and financial reporting standards is needed.
- Capacity to better assess the creditworthiness of real sector enterprises is needed.

Market Discipline:

- General weaknesses when it comes to availability of information on/from companies. Information from companies is not as transparent as information from/on banks.
- Corporate governance remains weak in the real sector and in some parts of government.
- Improvement in the detail, timing and accessibility of property registry data linked to bank loans and other credit exposures is needed.

Safety Net:

- The banking agencies believe deposit insurance limits are low (KM 7,500) and should be raised, although this needs to be assessed and determined in conjunction with other parties and issues regarding moral hazard and contingent risks.

Assessment of Compliance with European Union Standards

There are many gaps in the overall recommended EU framework for effective banking supervision. The most important to the EU is the current decentralized, dual-entity approach to banking supervision, which the EU (and other parties) finds to be sub-optimal in terms of efficiency, effectiveness, and ultimate compatibility with the requirements of EU membership.

There are no real benchmarks for the EU to utilize within the 27-member community due to the single-entity approach adopted by EU member states for banking supervision. Such issues would be expected to complicate future discussions of EU *membership*, although they should not be impediments to ongoing EU *integration* in the coming years.

Key priorities for the EU moving forward under the current dual-entity arrangement in BiH focus on strengthening the central bank. Priorities include:

- Better information of the CBBH on banking supervision issues.
- Setting up a Main Indicator table for the CBBH Management Committee.

- Implementing MoUs with main home foreign supervisors and developing cooperation with other BiH financial supervisors.
- Exchanging information with the banking industry and all parties involved in bank audits.
- Providing CBBH with information on banks' liquidity.
- Providing CBBH with information on banks' potential problems.
- Setting up emergency procedures for crisis situations.
- Implementing consultative procedure of CBBH prior to enforcement sanctions by the agencies.
- Implementing consultative procedure of CBBH prior to issuance of any draft regulation by the agencies.
- Implementing a common human resource policy.
- Setting up common administrative functions.
- Implementing a common supervisory disclosure policy.
- Identifying differences in call reports and regulations, and revising them for consistency with EU standards.
- Implementing a common off-site monitoring methodology.
- Implementing a common methodology for agencies' on-site examinations and remedial actions.

Assessment of Compliance with IOSCO Principles

The general detachment of banks from the capital markets in BiH indicates there are currently no significant capital markets issues to be dealt with from a supervisory perspective. Banks do not rely on the capital markets for funding or liquidity management, nor do they have much exposure via investments. (The limited inter-bank market also shows very limited reliance on banks or other markets for liquidity management.)

As banks are gradually permitted to increase their exposures and seek funding from the capital markets, risk issues will emerge. As such, it is essential that the capital markets meet the conditions for soundly functioning markets in the future so that risks can be properly identified, measured, monitored and managed.

The banking supervision agencies have not developed detailed plans or programs for IOSCO-related activities or their impact on the banks, although they are seeking to arrive at multilateral agreements for information exchange via IOSCO. In both entities, the banks are permitted to engage in brokerage and trading activities on the exchanges. However, as noted, there is limited activity as of now by the banks in BiH securities markets.

The EU CARDS program anticipates more information exchange on securities markets and better coordination and cooperation among the various regulatory agencies involved in banking and securities markets. This is projected for achievement within a 1-3 year time horizon from the start of the program (which began in 2007). Data exchange is currently in process regarding brokerage operations. The agencies have also stated they plan to sign MoUs with the Securities Commissions in 2008, and this will enhance coordination and cooperation.

While the banking agencies have not focused on the securities markets, there will be scope for increased attention as supervisory issues emerge. Future development and complexity of the financial system will require that the supervisory agencies increase capacity to monitor for potential risks to banking system safety, soundness and stability.

The Securities Commissions anticipate priorities in the next few years to include:

- Multilateral Agreements via IOSCO for information exchange with other commissions.
- Preparations for EU integration and eventual accession.
- Upgrades of IT, hardware, software, and staff training.
- Strengthened standards for corporate governance.
- Possible development of a government securities market.
- General efforts to increase market activity, including liquidity in the secondary markets.

Implications of Mid-2008 Gaps on Banking Stability

There is practical recognition by the two banking supervisory agencies of prominent risks they face in the banking system, as well as anticipation of future risks as the system evolves and eventually becomes more complex.

- Credit risk is generally well contained, but there are still problems associated with loan classification, loan loss provisioning, and the absence of consolidated accounts.
- Market risk is a relatively new area for many BiH banks.
- Operational risk is a clear challenge in BiH, as it is a relatively new area that was not well developed under the original Basel Capital Accord.
- The agencies do not supervise based on consolidated accounts.
- Future complexity is expected as banks diversify their operations.
- An eventual increase in exposures of BiH banks outside of Bosnia-Herzegovina is anticipated.
- The very nature of supervision will likely need to change over time from a two-entity approach to a more centralized and national approach linked institutionally to the CBBH, or perhaps as part of a larger unified financial services regulator.

Both agencies noted that they need specific assistance to implement Basel II as they have limited or no experience with some of the more sophisticated aspects of the framework. This is particularly the case with internal ratings-based models, which are not likely to be put into effect any time soon except at the largest banks (e.g., Unicredit, Raiffeisen, possibly a few others). Other issues, such as securitization, credit derivatives, market risks associated with futures, options and swaps, advanced market risk simulation models and metrics, and the Advanced Measurement Approach for operational risk should be deferred until a future point when fundamental aspects of Basel II are well in place.

Recommendations for Effective Banking Supervision

1. General Approach

In light BiH history since 1995-96 and the development of banking supervision capacity, it is recommended that the agencies build on the existing CAMEL framework, adapt it to Basel II (e.g., add Sensitivity to Market Risk), and incorporate other enhancements

and requirements based on the Basel II framework. Notwithstanding the ambitious plans of the agencies to implement Basel II and to be compliant with EU Directives, there is already a foundation on which to build a suitable model.

The agencies should take a gradual approach to implementation, recognizing a solid foundation will be needed before more complex forms of risk-based supervision are introduced. In some cases, this reflects limitations on the banks and supervision agencies. In other cases, it simply reflects weaknesses in external requirements (e.g., data for advanced modeling needed for Internal Ratings-Based systems or Advanced Measurement Approaches, land registry and use for secured transactions, role of outside appraisers).

The agencies should review Basel II components and develop a vision, strategy and action plan for what is expected to be a suitable framework based on how the banking system evolves over time. In this regard, the agencies should prepare for more complex, diverse financial institutions consistent with the "universal" model commonly found in Europe. The agencies will need to prioritize risks and resources/focus, focus on safety and soundness, and consider certain initiatives that will allow the agencies to efficiently manage the supervisory burden.

The agencies need regular engagement for sustained support. A qualified long-term advisor would be preferable, but this may not be feasible. As a result, USAID/PARE should try to supply regular assistance as needed on a demand-driven basis so that there is sustained support based on the priority needs of the agencies.

As a starting point, a workshop should be planned to produce a road map to Basel II compliance, essentially a vision and strategy/action plan for the key principles and requirements for design of a suitable Basel II framework for BiH. Key inputs should be a summary document on Basel II and relevant issues for BiH. Critical issues should be discussed and identified, and these should be the focus of near-term assistance for both agencies. The scope of the workshop should include coordination with CBBH, particularly with regard to its financial stability assessments, and EU Directives. Key output from this workshop should be the draft of the action plan that would detail how the agencies and relevant other institutions intend to proceed within the context of Basel II.

2. Role of the CBBH

The role of the CBBH and its ability to monitor a broad range of risks is critical to the underlying macro-financial stability of BiH. While the legal framework under the currency board regime limits the scope of its involvement in banking supervision, its powers to coordinate the respective banking supervision agencies is seen as essential in carrying out its responsibilities regarding monetary policy and financial stability. The USAID/PARE program should support the EU and other institutions supporting capacity enhancement in this domain. In particular, the program can help with areas where the EU CARDS program (and future programming) has been held up as a result of differing views on the entity-oriented approach to banking supervision in BiH. Specific areas of potential involvement can be identified by the CBBH, particularly as the financial stability assessment process evolves.

A key area of support that could be integrated into USAID's efforts to strengthen banking supervision would be to enhance the capacity of the supervisory agencies to utilize the findings from financial stability assessments for their own supervisory

purposes. This can be done as part of the larger effort to link macroeconomic and financial stability issues of potential risk to the specific aspects of banks' capital, asset quality, earnings, liquidity management, and overall operations. Specific exercises would include capacity among supervisors to conduct scenario analysis and stress tests of specific bank portfolios based on existing or anticipated risks. This could and should be coordinated with CBBH as a structural component of larger financial stability assessments. In the meantime, for the supervisory agencies, this would transform their scope from traditional credit-oriented regulation and supervision to a broader macro-prudential focus that would account for the larger risks associated with the economy and how these interact with the presence of more diversified and complex banks.

3. Proposed Assistance for the Banking Supervisory Agencies

Core areas of focus and assistance should include:

- **Strategic planning for design and implementation of a suitable Basel II framework and timeline for BiH**. Background information on the Basel II framework and how this could be applied and implemented in BiH is needed. This includes all three pillars—(1) minimum risk-adjusted capital; (2) supervisory review; and (3) market discipline—encompassing multiple approaches regarding credit risk, market risk and operational risk. Background information should draw on relevant models that would be potentially of use to BiH for application over a roughly five to six year period. The action plan could also identify critical areas of support from or linkage to EU institutions to assist with the harmonization and integration process.

- **Training and additional assistance to make it easier for the banking system to comply with new guidelines on market risk**. The initial focus should include verification that guidelines issued are consistent with the Basel II framework. Training would include a review of Tier 3 methods recommended by the Basel Committee that have been adopted for standardized approaches. This would help the Agencies to develop capacity to monitor and manage exchange rate, interest rate and (re-)pricing risk as a part of larger market risk. This is a key priority as expressed by both agencies, and would help them address FSAP recommendations on strengthening capacity on capital adequacy and market risk.

- **Assistance with the introduction of consolidated accounting and supervision**. This will require translation of some accounting standards dating back to 2005, as well as focus on the structure, operations and finances of conglomerates (financial holding companies, bank holding companies, banking groups). This can include full consolidation methods, the equity method, and the proportional consolidation method. Capacity-building in this direction will help the agencies supervise banks as they expand their activities in BiH to help diversify their earnings stream and increase their balance sheets. This will also help the agencies address several FSAP recommendations where movement to consolidated supervision was recommended.

- **Efforts should be made to strengthen coordination with the CBBH on financial stability issues**. The nature and complexity of banking supervision will change as the financial system develops. In addition to core Basel II issues to be adapted over time, the banking supervision agencies will benefit from enhanced knowledge of financial stability indicators and the linkages between macroeconomic and structural (microeconomic, banking-specific, and prudential) developments. This is important for all aspects of capital calculations (credit, market and operational risk), particularly as increased cross-border exposures and trade/investment are expected over time.

- **Coordination with the EU and Committee of European Banking Supervisors (CEBS) to ensure that BiH supervisory standards and practices are consistent with EU requirements for harmonization and convergence**. Initially, the focus should be on Basel II fundamentals. However, over time as integration deepens, there is likely to be increased focus on convergence. At a minimum, while focusing on methods to implement Basel II, the agencies will want to ensure they are following principles and practices consistent with European standards for effective supervision. This can be coupled from the outset with a focus on EU Directives noted above in the text to ensure regulations and supervisory practices are consistent with EU standards. In this regard, the recommendation focuses on technical aspects of supervision, and does not specifically address the issue of how banking supervision is organized within BiH.

- **Assistance should also focus on anticipated diversification and complexity of activities as the financial system evolves**. This will require increased familiarity with banking products/services, such as the implications involved for risk management and portfolio management. At a minimum, this could involve improved understanding of capital market products (e.g., money markets, bonds, equities), the role of derivatives and hedges, and fundamentals of securitization. In this regard, such capital markets-based activities will need to be understood from a risk management perspective. While entailing risks, such tools also provide banks with the means to manage liquidity as well as to diversify the earnings stream from their portfolios. However, in this regard, a clearer framework regarding securities and derivatives trading will need to be developed, with particular focus on how volatility can impact bank balance sheets, earnings, and liquidity and risk management. IOSCO-related guidance for securities markets can be part of the effort, and the agencies should plan to increase their coordination with securities commissioners to ensure that this process supports the agencies' supervisory requirements concerning capital adequacy, liquidity management, and credit and market risk management.

- **Work will be required in the implementation of appropriate accounting standards**. Particular emphasis can be focused on IAS 32 and 39 with regard to the financial reporting of complex financial instruments (IAS 32) and provisioning and general financial reporting (e.g., balance sheets, income statements) (IAS 39). As with provisioning and other similar challenges where regulations and accounting principles have not always been consistent, BiH will need to determine how practical applications of IAS 39 will affect the banks as a whole as well as on an individual basis. IAS 32 will need to be introduced in anticipation of gradual increases in the complexity of products and their valuations.

- **The agencies will need to work with the banks to ensure that loan classification is accurate**. With provisioning and loan loss reserve guidelines likely to be developed in 2008, it will be essential to validate that banks are not only following these guidelines, but are accurately classifying their loans in the first place. This may require additional targeted inspections with banks whose internal audit functions may not be considered sufficiently strong or autonomous.

- **Assistance should be provided to help with development of a clearer framework regarding country and transfer risk**. This should be developed according to Basel II, highlighting the role of external credit agencies and market discipline (pillar III) notwithstanding the current standing of the rating agencies in international markets.

- **The agencies should consider development of an information service to improve the public's understanding and importance of banking supervision with regard to deposit safety, banking system soundness, and consumer protection**. This would also be a key part of efforts to promote market discipline (pillar III) of the Basel II framework.

INTRODUCTION

A. Background

Michael Borish and Company, Inc. (MBC) has been hired by Chemonics International under the USAID-funded Partnership for Advancing Reforms in the Economy (PARE) program to provide the banking supervision agencies of the Federation (FBiH) and Serb Republic (RS) of Bosnia-Herzegovina (BiH) with an assessment and recommendations on how to move closer to full compliance with Basel Core Principles (BCPs) for banking supervision, and to develop a stronger, risk-based supervisory system. Specific activities and outputs completed under the sub-contract include:

A general assessment of the FBiH and RS banking agencies' supervision in terms of the following:

- Compliance with Basel I and Basel II, *Acquis Communautaire* and related directives of the EU, IOSCO, and other international standards.
- Evaluation of the relevant entity legislation (Law on Banks and implementing regulations) to identify similarities and differences between the two entities' legislation.
- Evaluation of the recommendations of international donors concerning BiH banking supervision.
- Review of existing practices and procedures for on-site and off-site supervision, including current supervision tools and data collection practices.

- **Assistance to the FBiH and RS banking agencies to**:
  - Prepare an action plan to strengthen and develop risk-based banking supervision.
  - Assist with the identification and articulation of needs of the respective agencies, including the sequencing of assistance priorities to strengthen banking supervision and bring it into compliance with Basel I and Basel II, *Acquis Communautaire* and related directives of the EU, the International Organization for Securities Commissions (IOSCO), and other international standards.

This report constitutes the findings from the above-mentioned assessment, as well as the preliminary action plan to assist the agencies to achieve an effective risk-based supervisory system.

B. Methodology

As per the Scope of Work (SOW), MBC developed a preliminary questionnaire by which to evaluate progress or actions taken since the last published Basel Core Principles assessment in 2006.[1] These principles capture the information needed to determine compliance with Basel, IOSCO, EU and other principles, including legal framework issues, on-site and off-site procedures and practices, and recommendations

[1] The IMF and World Bank jointly conducted a Financial System Stability Assessment (FSSA) and Financial Sector Assessment Program (FSAP) in 2006, with the results published in September 2006. This included a summary of areas where the supervisory agencies needed to take action to bring them closer to full compliance with the Basel Core Principles. Confidential reports were also shared by the two agencies which provided more detail than the publicly disclosed reports.

from the international community on how to bring the agencies into closer compliance with Basel Core Principles and international standards for banking supervision. Responses to the questionnaire have been summarized and are presented in Appendices 1 and 2, respectively reporting the findings from the two supervisory agencies. These focus on areas of progress since 2006 in banking supervision, as well as future needs for development and eventual full compliance. There is also reference to preconditions for effective banking supervision, including infrastructure and market discipline issues that impact the functioning of the legal framework (e.g., land registry) and information flows.

An effort has been made to identify any major gaps re the European Union or IOSCO, as per the SOW. As the EU has officially begun its implementation of Basel II beginning January 1, 2007, any deviation from BCPs is considered a deviation from EU directives or *acquis communautaire*. At the same time, given the flexibility within Basel II in terms of standardized approaches and national timelines for achievement, this does not imply intent on the part of the respective supervisory agencies. Rather, this is interpreted as simply part of the ongoing effort to achieve full compliance with all recognized international standards in due time without having yet achieved this goal. It is recognized and accepted that this will be an ongoing process for the foreseeable future.

To the extent that major deviations were uncovered with regard to EU directives, these are addressed below in the text. **The two supervisory agencies have made a point of focusing on legal, regulatory and supervisory practices that are consistent with EU principles and intent**. In some cases, requirements that are consistent with Basel Core Principles are enshrined in BiH legislation,[2] which make them broadly harmonized with EU Directives. However, by and large, **the very existence of the two entities' supervisory agencies represents a deviation from EU practices and recommended principles**. Among the existing 27 EU members, there are no examples of multiple banking supervisory agencies within the national or domestic market. EU experts have noted that the existence of the dual agency approach is not only "sub-optimal", but that EU membership itself implies establishment of a single banking market, and by extension, a single banking regulator.[3] As such, the EU position, along with that of much of the "international" community as well as many parties in BiH, is that banking supervision should eventually become a "state-level" function as is the case with deposit insurance and insurance supervision. The position taken is that banking supervision should be housed in the CBBH, as recommended by the IMF/World Bank in the 2006 assessment, and formally stated by the European Commission in 2007.[4] However, the dual agency framework that currently exists does not preclude *effective* banking supervision, particularly given the existing high level of cooperation and coordination that currently exists between the two entity-level agencies. Rather, the decentralized approach is considered less *efficient* administratively, and less suitable for the future as CBBH takes on greater responsibility for monitoring financial stability developments as part of its mandate as the central bank. **This report bypasses the political differences surrounding the question, and presents recommendations on the assumption that the current entity-based system will remain in effect for the foreseeable future**.

[2] For example, see article 69 in the Law on Changes and Amendments to the Federation Law on Banks (2002) which specifies that regulations are based on the Basel Core Principles. Article 128 of the RS Law on Banking likewise refers to the application of Basel Core Principles.

[3] See "CARDS Programme for the Central Bank of Bosnia and Herzegovina—Needs Analysis", European Union, March 20, 2007.

[4] See Council Decision, 2007/657/EC.

In the case of IOSCO, an effort has been made to ascertain areas of compliance or non-compliance, recognizing that the banking agencies focus on the banks and not the capital markets. IOSCO standards are largely geared to securities markets that are not centrally focused on banks. Rather, banks that are closely supervised by securities regulators tend to be more complex institutions with active participation in the capital markets involving investment, trading and hedging for their own portfolios and risk management requirements as well as on behalf of other clients. Likewise, while there is a reconciliation of principles between BIS and IOSCO for their respective areas of focus,[5] their focus is not identical. As such, given the mandate of the FBiH and RS supervision agencies to monitor developments in the banking sector, the assessment of the two agencies relative to IOSCO principles is more related to how this impacts banking supervision. In reality, the banking system and capital markets in BiH have not yet evolved to the point where there is anything more than limited exposure of banks to the capital markets. Based on year-end 2007 data, the banking system in BiH only had KM 58.6 million in exposure to securities, equivalent to 3 percent of total system capital and only 0.3 percent of banking system assets.[6] Thus, rather than a full-blown assessment of compliance with IOSCO principles,[7] which was considered premature in 2006 and remains premature, a description of how the existing system reconciles with fundamental IOSCO principles is highlighted in the report. Most specifically, issues as they apply to risk-based supervision are highlighted, mainly focused on financial stability, risk-based supervision, and how developments in the capital markets impact banks' earnings, funding and capital as well as operational and broader risk management practices. **As of mid-2008, there is little impact of the capital markets on banks' assets, funding, earnings, or operations**.

The banking supervision questionnaire was structured to follow the existing version of the Basel Core Principles as published by the Bank for International Settlements (BIS) as of October 2006.[8] The corresponding numbers and principles were partly reconfigured and restructured with this publication, representing a slight modification of the traditional BCPs, primarily to pave the way for adaptation from Basel I to Basel II. Thus, the current mapping is based on the existing BCPs, which are slightly different from the BCPs in force at the time of the 2006 assessment.

The questionnaire also includes space for each supervision agency to identify current status, actions taken since 2006, and existing/future needs to achieve effective risk-based supervision. These templates follow the current BCP version, and seek to reconcile the proposed actions in 2006 with the current BCPs. The earlier BCPs are noted in parentheses in these templates.

From these questionnaires and interviews with personnel from the banking supervision agencies along with a review of other information from a range of sources, the report below presents key findings and recommendations for the two banking supervision agencies to achieve effective risk-based supervision. A list of meetings and bibliography are presented at the end of the report.

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[5] See "Core Principles—Cross-Sectoral Comparison", Joint Forum, November 2001.

[6] Figures are simple combinations of securities and asset figures from the balance sheets of the banking systems at the end of 2007, as reported by the respective supervisory agencies. These securities were generally "trading securities" as opposed to "securities held until maturity".

[7] See "Objectives and Principles of Securities Regulation", IOSCO, May 2003.

[8] See "Core Principles for Effective Banking Supervision", Bank for International Settlements, October 2006.

ASSESSMENT

Part 1: Summary of Developments from the 2006 BCP Assessment

A. Status as of Year-end 2006

Based on the FSSA/FSAP carried out by the IMF and World Bank in 2006, the two banking supervisory agencies and banking systems had similar areas of compliance, partial compliance or material non-compliance with BCPs. The one key difference between the two had to do with independence, which was found to be largely in place in the Federation but materially non-compliant in RS. In this regard, legislation in Republika Srpska is more restrictive of RSBA capacity to operate independently due to the revocation of immunity and protection provided to RSBA supervisors. This is not the case in the Federation, and this remains the key difference in what is otherwise a generally similar legal framework for banking and banking supervision in the two entities. The following summarizes the 2006 assessment for both entity agencies:

Table 1: Summary of Compliance and Non-Compliance of Banking Agencies with Basel Core Principles as of mid-2006

Compliant	Objectives, enforcement powers, legislation on permissible activities, licensing criteria, ownership and investment criteria, conditions for connected lending, internal control and audit, practices regarding money laundering and terrorism financing, and overall contact with bank management.
Largely Compliant	Legal framework, information sharing, capital adequacy, credit policies, on-site and off-site supervision, validation of supervisory information, accounting standards, and remedial/corrective actions.
Materially Non-Compliant	Independence of the RSBA (the Federation Banking Agency was largely compliant), legal protection for supervisors, loan evaluation and loan-loss provisioning standards, large exposure limits, provisions for country, market and other risks, the absence of consolidated supervision, and supervision of foreign banks.
Not Applicable	Globally consolidated supervision and host country supervision were not considered applicable.
Source: Author's summary of findings from "Bosnia and Herzegovina—Detailed Assessments of Compliance with Standards and Codes", FSAP, May 2006	

From the areas of material non-compliance, the major actions recommended for improvement included:

- CP #1: **Strengthening independence of the agencies and legal protection of supervisors**, and specifically in the case of the RSBA, the provision of adequate resources and faster approvals of staff appointments to strengthen capacity and independence.
- CP#1: **Improving information sharing**, both domestically (Securities Commissions) and via Memoranda of Understanding with foreign supervisors, particularly countries of foreign bank origin.
- CP #6: **Determining regulatory capital on a more risk-adjusted basis to account for market, country, transfer and operational risks.**
- CP #7: Issuing more precise guidelines and **increasing capacity to monitor market, operational and other risks.**
- CP #8: Strengthening capacity to identify/monitor credit risk by **validating bank**

systems' provision of reliable data/information.

- CP #9: **Improving loan loss provisioning standards** by issuing more precise guidelines and building up reserves for currency-indexed loans.
- CP #10: **Analyzing large exposures on a consolidated basis** and strengthening capacity to validate collateral valuation.
- CP #11: **Analyzing related-party exposures on a consolidated basis.**
- CP #12: **Addressing the need for country and transfer risk guidelines.**
- CP #13: **Introducing capital charges for market risks**, particularly foreign exchange-related risks, and enhancing capacity to monitor/contain these risks.
- CP #15: **Issuing guidelines to better manage operational risk.**
- CP #16: **Issuing guidelines to better manage interest rate risk.**
- CP #17: **Issuing guidelines to banks' internal audit and control departments to better manage interest rate, operational and systems risk.**
- CP #20: **Strengthening supervisory techniques** via on-site supervision and off-site surveillance by strengthening capacity to validate banking information and assess market and other risks.
- CP #21: **Strengthening supervisory reporting** by analyzing reports on a consolidated (as well as solo) basis, validating banking information, clarifying auditor qualifications, and having the power to revoke auditor licenses.
- CP #22: **Strengthening accounting and disclosure** by implementing IAS and qualifying auditors.
- CP #23: **Improving corrective action tools** by allowing the agencies to levy more costly fines on banks for violations.
- CP #24: **Moving to consolidated supervision** by analyzing risks of the non-financial activities of banks' operations.
- CP #25: **Improving cooperation with foreign supervisors** via MoUs and enhanced information exchange.

The following table presents areas of needed improvement and the recommendations made for improvement. (These are organized based on the current BCPs, not those in effect in early 2006. Actions seek to reconcile with the original BCP number. Where practices were in compliance, these are noted as such.)

Table 2: Summary of BCP Status and Recommended Actions in 2006

CP #	Principle	Areas of Needed Improvement	Recommended Actions
1	Objectives, Independence, Powers, Transparency and Cooperation	Operational independence, transparent processes, sound governance and adequate resources, and accountable for discharge of duties	FBiH: Strengthen corporate governance—2006 assessment = CP1.2 (Independence)
			RSBA: Guarantee adequate financial resources for RSBA, and review salary scales and staffing needs—2006 assessment = CP1.2 (Independence); Ensure acting appointments to RSBA are confirmed without excessive delay—2006 assessment = CP1.2 (Independence)
		Suitable legal framework, including provisions re authorization of banking establishments and their ongoing supervision, powers to address legal compliance and safety and	FBiH: Amend secondary legal framework and ongoing supervisory practice—2006 assessment = CP1.3 (Legal Framework); Provide comprehensive legal protection and coverage of legal defense costs—2006 assessment = CP1.5 (Legal Protection)

		soundness concerns, and legal protection for supervisors	RSBA: Amend secondary legal framework and ongoing supervisory practice—2006 assessment = CP1.3 (Legal Framework); Amend law in order to ensure legal protection to supervisors—2006 assessment = CP1.5 (Legal Protection)
		Arrangements for sharing information between supervisors and protecting confidentiality of such information	Conclude MoU with the Securities Commission—2006 assessment = CP1.6 (Information Sharing)
2	Permissible Activities	Compliant	None
3	Licensing Criteria	Compliant	None
4	Transfer of Significant Ownership	Compliant	None
5	Major Acquisitions	Compliant	None
6	Capital Adequacy	Set prudent and appropriate minimum capital adequacy requirements for banks that reflect their risks	Account for market risk, country risk, and transfer risk in capital analysis and requirements—2006 = CP6 (Capital Adequacy)
			Consult Rating Agencies regarding ratings for Government and CBBH obligations—2006 = CP6 (Capital Adequacy)
		Define components of capital and ability to absorb losses	Establish capital requirements for other risks—2006 = CP13 (Other Risks)
7	Risk Management Process	Banks and banking groups must have comprehensive risk management processes (including Board and senior management oversight) to identify, evaluate, monitor and control/mitigate material risks and assess their overall capital adequacy in relation to their risk profile	Issue specific standards for risk management that cover and better enforce interest rate, operational and systems risks—2006 = CP13 (Other Risks)
			Establish capital requirements for other risks—2006 = CP13 (Other Risks)
			Training should be increased and the guidelines for examination procedures for other risks should be incorporated into the On-Site Supervision Manual—2006 = CP13 (Other Risks)
			Supervisors require targeted training in the area of market risks—2006 = CP16 (On-site and off-site supervision)
8	Credit Risk	Banks and banking groups must have credit risk management process that takes into account the risk profile of the institution, with prudent policies and procedures to identify, evaluate, monitor and control credit risk, including counterparty risk, including origination of loans and making investments, evaluation of the quality of assets, and ongoing management of loan and	IT specialists to assess the reliability and accuracy of the information supplied by the banks related to lending—2006 = CP7 (Credit Policies)

		investment portfolios	
9	Problem Assets, Provisions and Reserves	Banks must establish and adhere to policies and processes for managing problem assets and evaluating the adequacy of provisions and reserves	Revise definitions of loan categories and revise percentage of loan loss reserves—2006 = CP8 (Loan Loss Provisioning)
			Establish reserves for foreign currency-indexed loans—2006 = CP8 (Loan Loss Provisioning)
10	Large Exposure Limits	Banks and banking groups must have policies and processes that enable management to identify and manage concentrations within the portfolio	Analyze large exposures on a consolidated basis—2006 = CP9 (Large Exposure Limits)
			Improve the quality of information required to evaluate collateral—2006 = CP9 (Large Exposure Limits)
11	Exposure to Related Parties	Requirements in place that banks extend exposures to related companies and individuals on an arm's length basis	Analyze connected lending on a consolidated basis—2006 = CP10 (Connected Lending)
12	Country and Transfer Risks	Banks have adequate policies and processes to identify, measure, monitor and control country risk and transfer risk in their international lending and investment activities	Issue a decision specifically addressing country risk—2006 = CP11 (Country Risk)
13	Market Risks	Powers to impose specific limits and/or specific capital charge on market risk exposures if warranted	Introduce capital charges for foreign exchange and other market risks—2006 = CP12 (Market Risk)
			Supervisors require targeted training in the area of market risks—2006 = CP16 (On-site and off-site supervision)
14	Liquidity Risk	Compliant	None
15	Operational Risk	Banks and banking groups must have risk management policies and processes to identify, assess, monitor and control/mitigate operational risk	Issue specific standards for risk management that cover and better enforce interest rate, operational and systems risks—2006 = CP13 (Other Risks)
16	Interest Rate Risk in the Banking Book	Banks and banking groups must have effective systems in place to identify, measure, monitor and control interest rate risk in the banking book	Issue specific standards for risk management that cover and better enforce interest rate, operational and systems risks—2006 = CP13 (Other Risks)
17	Internal Control and Audit	Banks have in place internal controls that are adequate for the size and complexity of their business	Issue specific standards for risk management that cover and better enforce interest rate, operational and systems risks—2006 = CP13 (Other Risks)
18	Abuse of Financial Services	Compliant based on Money Val assessment	None
19	Supervisory Approach	Compliant	None
20	Supervisory Techniques	Effective on-site supervision	Training should be increased and the guidelines for examination procedures for other risks should be incorporated into the On-Site Supervision Manual—2006 = CP13 (Other Risks)

			Supervisors should enhance their expertise in verifying the accuracy of financial statements and management information—2006 = CP16 (On-Site and Off-Site Supervision)
			Supervisors require targeted training in the area of market risks—2006 = CP16 (On-Site and Off-Site Supervision)
		Effective off-site surveillance	Supervisors should enhance their expertise in verifying the accuracy of financial statements and management information—2006 = CP16 (On-Site and Off-Site Supervision)
			Supervisors require targeted training in the area of market risks—2006 = CP16 (On-Site and Off-Site Supervision)
			Supervisors should collect, review and analyze reports from banks on a solo and consolidated basis—2006 = CP18 (Off-site Supervision based on Bank Reports)
21	Supervisory Reporting	Means of collecting, reviewing and analyzing prudential reports and statistical returns from banks on a solo and consolidated basis	Supervisors should collect, review and analyze reports from banks on a solo and consolidated basis—2006 = CP18 (Off-site Supervision based on Bank Reports)
		Means of independent verification of above reports via on-site examinations or use of external experts	IT specialists who can assess the reliability and accuracy of the information supplied by the banks in the loan area required—2006 = CP19 (Validation of Supervisory Information)
			Formally define qualifications of external auditor, and grant FBA the power to revoke an auditor's license—2006 = CP21 (Accounting Standards)
22	Accounting and Disclosure	Each bank maintains adequate records drawn up in accordance with accounting policies and practices that are widely accepted internationally	Implementation of IAS is required and should become effective in 2007—2006 = CP21 (Accounting Standards)
			Formally define qualifications of external auditor, and grant Agencies the power to revoke an auditor's license—2006 = CP21 (Accounting Standards)
23	Corrective and Remedial Powers of Supervisors	Adequate range of supervisory tools to bring about timely corrective actions	Increase maximum amount of fines—2006 = CP22 (Remedial Measures)
24	Consolidated Supervision	Supervision on a consolidated basis as well as solo	Implement a supervisory framework for evaluating risks arising from non-financial activities of a banking group—2006 = CP20 (Consolidated Supervision)
25	Home-Host Relationships	Cooperation and information exchange between home country supervisors and other supervisors involved, primarily host banking supervisors	Establish formal relations with foreign supervisors, including through MoUs—2006 CP25 (Supervision Over Foreign Banks' Establishments)
Source: Author's summary of findings from "Bosnia and Herzegovina—Detailed Assessments of Compliance with Standards and Codes", FSAP/FSSA, May 2006			

B. Actions Taken Since 2006 and Current Status in 2008 re BCPs

1. Developments in the Federation

In the Federation, a number of steps have been taken by FBA to improve compliance with the BCPs. Particular progress has been made with regard to the issuance of market risk requirements for banks, and improving information sharing with other regulators abroad. In 2007, FBA issued requirements and comprehensive instructions for banks to manage market risks. Such requirements will go into effect in late 2008 or 2009. With regard to information exchange, since 2006, FBA signed MoUs with supervisors in Albania, Greece, Macedonia, Romania, Bulgaria, Serbia, Montenegro, Cyprus, and Slovenia. There will soon be an agreement with Italy, and cooperation with Turkey has also increased. There are plans to conclude a MoU with the Securities Commission, and an agreement with the Deposit Insurance Agency has been in force. Meanwhile, coordination with the RSBA remains strong, and future activities related to CBBH financial stability initiatives portend strengthened coordination and cooperation.

Some progress has been made in other areas, and plans are under way to address these and other issues. Supervisors have not been subject to legal harassment that would undermine their independence. However, there is continued risk of potential political meddling that can undermine the independence of the agency. Governance among the banks is considered relatively strong, but more work is needed in the area of corporate governance as this relates to future exposures to the enterprise sector and securities markets. Preparation has begun to revise loan classification and provisioning requirements, and an existing set of requirements has been put in place that stresses disclosure of results based on regulatory requirements as well as more common international standards. Examiners have made progress in validating financial statements.

Despite progress, many of the recommendations made in 2006 remain to be put into effect. These include recommendations concerning capital adequacy, credit policies, loan loss provisioning, reserves for foreign currency-indexed loans, country and transfer risk, monitoring of exposures on a consolidated basis, operational risk, and the insufficiency of sanctions against professional violations uncovered in the banking sector. Appendix 1 presents a table that summarizes actions taken in the Federation since 2006, and current status or plans related to the major recommendations from the 2006 assessment.

2. Developments in Republika Srpska

Since 2006, a number of steps have been taken by RSBA to improve compliance with the BCPs. Particular progress has been made to ensure adequate financial resources, and to improve information sharing with other regulators inside BiH and abroad. RSBA claims that its tariff structure is sufficient to meet its operating needs, although it also claims it may need additional revenues to hire more people in the future as banks become more complex and technical requirements for RSBA become more challenging. This is considered a likelihood as new legislation requires RSBA to also supervise micro-credit organizations, savings organizations, and leasing companies. With regard to information exchange, since 2006, RSBA has signed MoUs with supervisors in Albania, Greece, Macedonia, Romania, Bulgaria, Serbia, Montenegro and Cyprus, and a formal exchange of supervisory reports is in effect with Slovenia. Within BiH, RSBA has close cooperation with the FBA, including joint examinations for banks operating in both entities. RSBA also plans to conclude a MoU with the Securities Commission, has an agreement with the Deposit Insurance Agency, and will soon sign a MoU with the CBBH on information exchange related to financial stability issues.

Partial progress has been made in a number of other areas, or plans are under way to address these issues. This includes market risk guidelines that will influence capital adequacy calculations when implemented, coordinated efforts with FBA to come up with a revised framework for loan loss provisioning and reserves, and better validation of supervisory information.

As with the FBA, despite progress, many of the recommendations made in 2006 remain to be put into effect. These include recommendations concerning capital adequacy, credit policies, loan loss provisioning, monitoring of exposures on a consolidated basis, market risk, and operational risk. Furthermore, **legal protection for supervisors is currently weaker than it was in 2006, as RSBA immunity for supervisors was revoked by the RS Parliament**. Appendix 2 summarizes actions taken since 2006 in RS, and current status or plans related to the major recommendations from the 2006 assessment.

C. Summary of Banking Supervision Gaps as of Mid-2008

1. General Summary

According to the two supervisory agencies, key challenges and risks are presented below (with references back to the original Core Principles, not the revised Principles, and notwithstanding progress and measures taken in many of these areas):

- CP #1: **Legal protection for supervisors** needs to be strengthened in RS, while the appointment process could be strengthened in the Federation.
- CP #6: Capacity to monitor and manage **interest rate and (re-)pricing risk as a part of larger market risk** has to be further developed. Particular emphasis on **exchange rate risk** is required.
- CP #7: **Banks' internal audit functions** sometimes need to operate more independently. **External audit firms** do not always meet international standards, although problem firms are generally excluded from conducting bank audits.
- CP #8: Banks need to fully comply with revised **loan classification and loan-loss provisioning** requirements once they are finalized.
- CP #11: A clearer framework regarding **country and transfer risk** will need to be developed.
- CP #12: A clearer framework regarding **securities and derivatives trading** will need to be developed, with particular focus on how volatility can impact bank balance sheets, earnings, and liquidity and risk management.
- CP #13: Greater capacity may need to be put in place to protect against the incidence of and losses from **money laundering and the financing of terrorism**, although findings from assessments suggest the banks are doing a reasonable job monitoring suspicious transactions.
- CP #14: **Banks' internal audit functions** will need more capacity, as do some **external audit firms**.
- CP #18 and #20: Banks will need to prepare and provide **consolidated financial statements** to the supervisory agencies, which they currently do not do.

- CP #23-25: **Enhanced information exchange and coordination with other supervisory agencies** to monitor cross-border exposures and risks will be needed.

Specific gaps in terms of BCPs are primarily focused on work to be done under Basel II, as well as outstanding initiatives that are in many cases partly under way or in process. In some cases, such as the signing of certain MoUs, or new parameters for loan classification/loan loss reserves or reserves for foreign currency-indexed loans, they are planned to take effect in 2008. In other cases, there are no firm time lines for achievement, such as training and revision of manuals and practices regarding market risk, operational risk, and country and transfer risk. In yet other cases, the two agencies are early in the planning stages, with general timelines for achievement, such as development of a customized Basel II model by the end of 2010, but without a specific program for achievement.

Some of the current objectives may be overly ambitious. For instance, both agencies want to implement the requirements for market risk and supervision on a consolidated basis by the end of 2008. This is unlikely to be feasible. Likewise, there are plans to implement the IRB approach and Pillar III of Basel II by the end of 2012. It is unclear if data will be sufficient, or if adequate modeling capacity will be in place within banking supervision or the banks by such a date.

2. Gaps in the Federation

In terms of the major preconditions for effective banking supervision, the Federation faces a number of ongoing challenges that are macroeconomic, infrastructure-related and institutional in nature. In many cases, these represent ongoing structural weaknesses in the legal environment and the real sector that continue to pose risks to banking stability, and require ongoing monitoring by FBA and the banks for the detection and management of risk. Key challenges that are specific to banking supervision include:

<u>Macroeconomic</u>:

- Better coordination of cross-border issues and their potential impact on BiH as the system is dominated by foreign Europe-based banks. Attention should be paid to rapid credit growth, partly funded by remittances, the current account deficit, and future potential risks such as speculative bubbles. Cooperation needs to be strengthened with "home supervisors".

<u>Infrastructure</u>:

- Better consumer protection legislation that specifies rights and responsibilities of all parties involved in transactions.
- Capacity for effective supervision of non-bank financial institutions may need strengthening, particularly in insurance, capital markets and leasing.
- Judges and other personnel in the legal system would benefit from a better understanding of the fundamental operations of banking supervision.
- Appraisers of assets do not always have the professional skills or integrity to produce accurate valuations.

<u>Market Discipline</u>:

- General weaknesses when it comes to availability of information on/from companies, which is not as transparent as information on/from banks.

- Corporate governance remains weak in the real sector and in some parts of government.

Safety Net:

- FBA believes insurance limits are low (KM 7,500) and should be raised.
- FBA also believes the Deposit Insurance Fund is small and would not survive a serious threat at a bank. However, this risk is partly mitigated by the Banking Law, which provides a mechanism for FBA to manage problem banks and compensate depositors prior to calling on funds of the Deposit Insurance Fund.

The following table highlights current gaps that will need to be addressed by FBA and banks in the Federation for the achievement of effective, risk-based supervision.

Table 3: Recommended BCP Actions in the Federation from 2006 and Outstanding Gaps as of 2008

CP #	Principle	Recommended Actions	Current Gaps
1	Objectives, Independence, Powers, Transparency and Cooperation	Strengthen corporate governance—2006 assessment = CP1.2 (Independence)	Corporate governance is considered reasonably sound in the banking sector, but suspect in the real sector. Potential political infringements continue to challenge FBA independence. Additional guidance on governance will help re future bank listings and issuances in securities markets.
		Amend secondary legal framework and ongoing supervisory practice—2006 assessment = CP1.3 (Legal Framework); Amend law in order to ensure legal protection to supervisors—2006 assessment = CP1.5 (Legal Protection)	Supervisors would benefit from training of court personnel to reduce risk of potential challenges to legal protection.
		Conclude MoU with the Securities Commission—2006 assessment = CP1.6 (Information Sharing)	MoUs with Securities Commission need to be signed.
6	Capital Adequacy	Account for market risk, country risk, and transfer risk in capital analysis and requirements—2006 = CP6 (Capital Adequacy)	Decisions on market risk are expected to become effective on December 31, 2008, but this may need education and training for effective implementation. Guidelines need to be developed for country and transfer risk.
		Consult Rating Agencies regarding ratings for Government and CBBH obligations—2006 = CP6 (Capital Adequacy)	Establish plans to obtain information on ratings of Government or CBBH obligations and determine appropriate risk weights for capital calculations based on Basel II framework to be developed.
		Establish capital requirements for other risks—2006 = CP13 (Other Risks)	Decisions on operational and other risk need to be developed. Agency will need to expand and intensify education and training of supervisors for operational risks, with preparation for Standardized Approach but starting with the Basic Indicators Approach.
7	Risk Management Process	Issue specific standards for risk management that cover and better enforce interest rate, operational and systems risks—2006 = CP13 (Other Risks)	See above re Capital Adequacy. Conduct needs assessment of requirements under more complex, risk-based conditions. Determine data and systems needs for stress testing and scenario analysis.
		Establish capital requirements for	See above re Capital Adequacy.

		other risks—2006 = CP13 (Other Risks)	
		Training should be increased and the guidelines for examination procedures for other risks should be incorporated into the On-Site Supervision Manual—2006 = CP13 (Other Risks)	See above re Capital Adequacy. Will need to update and revise manuals.
		Supervisors require targeted training in the area of market risks—2006 = CP16 (On-site and off-site supervision)	See above re Capital Adequacy. Conduct needs assessment of requirements under more complex, risk-based conditions. Determine data and systems needs for stress testing and scenario analysis.
8	Credit Risk	IT specialists to assess the reliability and accuracy of the information supplied by the banks related to lending—2006 = CP7 (Credit Policies)	Hire additional staff and/or purchase needed hardware/software to validate systems and accuracy of data under anticipated future scenarios featuring greater market risk and how this will affect credit quality.
9	Problem Assets, Provisions and Reserves	Revise definitions of loan categories and revise percentage of loan loss reserves—2006 = CP8 (Loan Loss Provisioning)	FBA plans to adopt changes and amendments to the Agency's Decision on minimum standards for credit risk management and assets classification by the end of 2008 together with RSBA. Instructions will need to be issued to the banks.
		Establish reserves for foreign currency-indexed loans—2006 = CP8 (Loan Loss Provisioning)	FBA plans to adopt changes and amendments to the Agency's Decision on minimum standards for credit risk management and assets classification by the end of 2008 together with RSBA. Instructions will need to be issued to the banks.
10	Large Exposure Limits	Analyze large exposures on a consolidated basis—2006 = CP9 (Large Exposure Limits)	Consolidated accounting will need to be introduced and implemented. The new Banking Law should include this.
		Improve the quality of information required to evaluate collateral—2006 = CP9 (Large Exposure Limits)	Standards for asset valuation may need refinement or adjustment (e.g., fair value accounting, independence of appraisers, validation of methods). Land registry and any other pledge registries need to be up-to-date, accurate and accessible electronically to lenders. Appraisers need training and observance of a code of ethics.
11	Exposure to Related Parties	Analyze connected lending on a consolidated basis—2006 = CP10 (Connected Lending)	Compliant with BCPs, but better systems and training may be needed for consolidated exposures once consolidated accounting and supervision are in force.
12	Country and Transfer Risks	Issue a decision specifically addressing country risk—2006 = CP11 (Country Risk)	Standards should be issued with CBBH. Basel II provides guidance.
13	Market Risks	Introduce capital charges for foreign exchange and other market risks—2006 = CP12 (Market Risk)	See above re Capital Adequacy. FBA following provisioning approach rather than capital charge approach for now.
		Supervisors require targeted training in the area of market risks—2006 = CP16 (On-site and off-site supervision)	See above re Capital Adequacy.
15	Operational Risk	Issue specific standards for risk management that cover and better enforce interest rate, operational and systems risks—2006 = CP13	See above re Capital Adequacy.

		(Other Risks)	
16	Interest Rate Risk in the Banking Book	Issue specific standards for risk management that cover and better enforce interest rate, operational and systems risks—2006 = CP13 (Other Risks)	See above re Capital Adequacy.
17	Internal Control and Audit	Issue specific standards for risk management that cover and better enforce interest rate, operational and systems risks—2006 = CP13 (Other Risks)	See above re Capital Adequacy.
20	Supervisory Techniques	Training should be increased and the guidelines for examination procedures for other risks should be incorporated into the On-Site and Off-Site Supervision Manuals—2006 = CP13 (Other Risks)	Guidelines (i.e., procedures for supervision of other risks) need to be incorporated into the on-site and off-site Manuals. Continue coordination with RSBA and CBBH.
		Supervisors should enhance their expertise in verifying the accuracy of financial statements and management information—2006 = CP16 (On-Site and Off-Site Supervision)	Increase training and capacity for supervisors to validate financial statements re market and operational risks. Continue coordination with RSBA and CBBH.
		Supervisors require targeted training in the area of market risks—2006 = CP16 (On-Site and Off-Site Supervision)	Additional training is planned. Continue coordination with RSBA and CBBH.
		Supervisors should collect, review and analyze reports from banks on a solo and consolidated basis—2006 = CP18 (Off-site Supervision based on Bank Reports)	Consolidated accounting will need to be introduced and implemented. This should be coordinated with all other relevant regulatory institutions in BiH, and be linked to financial stability assessments carried out by CBBH.
21	Supervisory Reporting	Supervisors should collect, review and analyze reports from banks on a solo and consolidated basis—2006 = CP18 (Off-site Supervision based on Bank Reports)	See Supervisory Techniques above.
		IT specialists who can assess the reliability and accuracy of the information supplied by the banks in the loan area required—2006 = CP19 (Validation of Supervisory Information)	See Supervisory Techniques above.
		Formally define qualifications of external auditor, and grant FBA the power to revoke an auditor's license—2006 = CP21 (Accounting Standards)	Compliant with BCPs (internal control and audit). FBA does not have power to revoke auditor's license.
22	Accounting and Disclosure	Implementation of IAS is required and should become effective in 2007—2006 = CP21 (Accounting Standards)	FBA will need to harmonize regulations with IAS/IFRS, particularly IAS 32 (financial instruments) and 39 (published assessment of loan losses, balance sheet and income statement). Arrange for timely translation of new standards, as well as outstanding standards—IAS 6, 7 and amendments and explanations of standards published in 2005, 2006, 2007 by IFAC and IASB are not

			translated.
		Formally define qualifications of external auditor, and grant Agencies the power to revoke an auditor's license—2006 = CP21 (Accounting Standards)	See Supervisory Reporting above.
23	Corrective and Remedial Powers of Supervisors	Increase maximum amount of fines—2006 = CP22 (Remedial Measures)	Initiate continuous review of effectiveness of corrective measures to determine suitability. New Banking Law should strengthen sanctions.
24	Consolidated Supervision	Implement a supervisory framework for evaluating risks arising from non-financial activities of a banking group—2006 = CP20 (Consolidated Supervision)	See Supervisory Techniques above.
25	Home-Host Relationships	Establish formal relations with foreign supervisors, including through MoUs—2006 CP25 (Supervision Over Foreign Banks' Establishments)	Propose protocols for signing MoU with FMA of Austria, possibly via CBBH or based on MoU to be signed with Bank of Italy.

3. Gaps in Republika Srpska

There are a series of preconditions for effective banking supervision that need strengthening in the RS. These will require the involvement of other parties in government as well as the private sector, and in some cases are outside the scope of the RSBA. Key gaps that can be closed in support of a better environment for risk-based supervision include:

Macroeconomic:

- Better cooperation with foreign supervisors to monitor the potential threat to macroeconomic and financial stability.

Infrastructure:

- Strengthened consumer protection legislation to be more precise about banks' obligations to depositors and other consumers.
- Harmonization of RSBA's regulations with international accounting and financial reporting standards (e.g., standard 39 is not applied for the assessment of credit losses, and balance sheets and income statements are not fully in compliance with IAS/IFRS framework).
- Capacity to better assess the creditworthiness of real sector enterprises.

Market Discipline:

- Improvement in the detail, timing and accessibility of registry data linked to bank loans and other credit exposures.
- Corporate governance measures for real sector enterprises to provide investors and creditors with greater confidence in financial and operational management.

Safety Net:

- There may be scope for increasing deposit insurance limits to induce greater confidence, although current limits of KM 7,500 seem adequate for most households relative to their savings in banks.

The following table highlights current gaps that will need to be addressed by RSBA and banks in RS for the achievement of effective, risk-based supervision.

Table 4: Recommended BCP Actions in RS from 2006 and Outstanding Gaps as of 2008

CP #	Principle	Recommended Actions	Current Gaps
1	Objectives, Independence, Powers, Transparency and Cooperation	Guarantee adequate financial resources for RSBA, and review salary scales and staffing needs—2006 assessment = CP1.2 (Independence); Ensure acting appointments to RSBA are confirmed without excessive delay—2006 assessment = CP1.2 (Independence)	Risk that delays in confirming appointments could be a problem in the future, undermining independence and efficiency of operations. Staggered schedules and terms for key appointments still not formally in force.
		Amend secondary legal framework and ongoing supervisory practice—2006 assessment = CP1.3 (Legal Framework); Amend law in order to ensure legal protection to supervisors—2006 assessment = CP1.5 (Legal Protection)	Authorities need to restore immunity to protect RS supervisors.
		Conclude MOU with the Securities Commission—2006 assessment = CP1.6 (Information Sharing)	MoUs with Securities Commission need to be signed.
6	Capital Adequacy	Account for market risk, country risk, and transfer risk in capital analysis and requirements—2006 = CP6 (Capital Adequacy)	Decisions are expected to become effective on December 31, 2008. Agency will need to expand and intensify education and training of supervisors for market risks, with focus on interest rate, exchange rate and pricing risk.
		Consult Rating Agencies regarding ratings for Government and CBBH obligations—2006 = CP6 (Capital Adequacy)	Establish plans to obtain information on ratings of Government or CBBH obligations and determine appropriate risk weights for capital calculations.
		Establish capital requirements for other risks—2006 = CP13 (Other Risks)	Decisions are expected to become effective on December 31, 2008. Agency will need to expand and intensify education and training of supervisors for operational risks, starting with the Basic Indicators Approach but planning for movement to Standardized Approach.
7	Risk Management Process	Issue specific standards for risk management that cover and better enforce interest rate, operational and systems risks—2006 = CP13 (Other Risks)	See above re Capital Adequacy. Conduct needs assessment of requirements under more complex, risk-based conditions. Determine data and systems needs for stress testing and scenario analysis.
		Establish capital requirements for other risks—2006 = CP13 (Other Risks)	See above re Capital Adequacy.
		Training should be increased and the guidelines for examination procedures for other risks should be incorporated into the On-Site Supervision Manual—2006 = CP13 (Other Risks)	See above re Capital Adequacy. Will need to update and revise manuals.
		Supervisors require targeted training in the area of market risks—2006 = CP16 (On-site and off-site supervision)	See above re Capital Adequacy. Conduct needs assessment of requirements under more complex, risk-based conditions. Determine data and systems needs for stress testing and scenario analysis.

8	Credit Risk	IT specialists to assess the reliability and accuracy of the information supplied by the banks related to lending—2006 = CP7 (Credit Policies)	Hire additional staff and/or purchase needed hardware/software to validate systems and accuracy of data under anticipated future scenarios featuring greater market risk and how this will affect credit quality.
9	Problem Assets, Provisions and Reserves	Revise definitions of loan categories and revise percentage of loan loss reserves—2006 = CP8 (Loan Loss Provisioning)	RSBA plans to adopt changes and amendments to the Agency's Decision on minimum standards for credit risk management and assets classification by the end of 2008 together with FBA. Instructions will need to be issued to the banks.
		Establish reserves for foreign currency-indexed loans—2006 = CP8 (Loan Loss Provisioning)	RSBA plans to adopt changes and amendments to the Agency's Decision on minimum standards for credit risk management and assets classification by the end of 2008 together with FBA. Instructions will need to be issued to the banks.
10	Large Exposure Limits	Analyze large exposures on a consolidated basis—2006 = CP9 (Large Exposure Limits)	Consolidated accounting will need to be introduced and implemented.
		Improve the quality of information required to evaluate collateral—2006 = CP9 (Large Exposure Limits)	Standards for asset valuation may need refinement or adjustment (e.g., fair value accounting, independence of appraisers, validation of methods). Land registry and any other pledge registries need to be up-to-date, accurate and accessible electronically to lenders.
11	Exposure to Related Parties	Analyze connected lending on a consolidated basis—2006 = CP10 (Connected Lending)	Compliant with BCPs, but better systems and training may be needed for consolidated exposures once consolidated accounting is in force.
12	Country and Transfer Risks	Issue a decision specifically addressing country risk—2006 = CP11 (Country Risk)	Standards should be issued with CBBH.
13	Market Risks	Introduce capital charges for foreign exchange and other market risks—2006 = CP12 (Market Risk)	See above re Capital Adequacy.
		Supervisors require targeted training in the area of market risks—2006 = CP16 (On-site and off-site supervision)	See above re Capital Adequacy.
15	Operational Risk	Issue specific standards for risk management that cover and better enforce interest rate, operational and systems risks—2006 = CP13 (Other Risks)	See above re Capital Adequacy.
16	Interest Rate Risk in the Banking Book	Issue specific standards for risk management that cover and better enforce interest rate, operational and systems risks—2006 = CP13 (Other Risks)	See above re Capital Adequacy.
17	Internal Control and Audit	Issue specific standards for risk management that cover and better enforce interest rate, operational and systems risks—2006 = CP13 (Other Risks)	See above re Capital Adequacy.
20	Supervisory Techniques	Training should be increased and the guidelines for examination procedures	Guidelines (i.e., procedures for supervision of other risks) need to be

		for other risks should be incorporated into the On-Site and Off-Site Supervision Manuals—2006 = CP13 (Other Risks)	incorporated into the on-site and off-site Manuals. Continue coordination with FBA and CBBH.
		Supervisors should enhance their expertise in verifying the accuracy of financial statements and management information—2006 = CP16 (On-Site and Off-Site Supervision)	Increase training and capacity for supervisors to validate financial statements re market and operational risks. Continue coordination with FBA and CBBH.
		Supervisors require targeted training in the area of market risks—2006 = CP16 (On-Site and Off-Site Supervision)	Additional training is planned. Continue coordination with FBA and CBBH.
		Supervisors should collect, review and analyze reports from banks on a solo and consolidated basis—2006 = CP18 (Off-site Supervision based on Bank Reports)	Consolidated accounting will need to be introduced and implemented. This should be coordinated with all other relevant regulatory institutions in BiH, and be linked to financial stability assessments carried out by CBBH.
21	Supervisory Reporting	Supervisors should collect, review and analyze reports from banks on a solo and consolidated basis—2006 = CP18 (Off-site Supervision based on Bank Reports)	See Supervisory Techniques above.
		IT specialists who can assess the reliability and accuracy of the information supplied by the banks in the loan area required—2006 = CP19 (Validation of Supervisory Information)	See Supervisory Techniques above.
		Formally define qualifications of external auditor, and grant FBA the power to revoke an auditor's license—2006 = CP21 (Accounting Standards)	Compliant with BCPs (internal control and audit).
22	Accounting and Disclosure	Implementation of IAS is required and should become effective in 2007—2006 = CP21 (Accounting Standards)	RSBA will need to harmonize regulations with IAS/IFRS, particularly IAS 32 (financial instruments) and 39 (published assessment of loan losses, balance sheet and income statement). Arrange for timely translation of new standards, as well as outstanding standards—IAS 6, 7 and amendments and explanations of standards published in 2005, 2006, 2007 by IFAC and IASB are not translated.
		Formally define qualifications of external auditor, and grant Agencies the power to revoke an auditor's license—2006 = CP21 (Accounting Standards)	See Supervisory Reporting above.
23	Corrective and Remedial Powers of Supervisors	Increase maximum amount of fines—2006 = CP22 (Remedial Measures)	Initiate continuous review of effectiveness of all 12 corrective measures to determine suitability.
24	Consolidated Supervision	Implement a supervisory framework for evaluating risks arising from non-financial activities of a banking group—2006 = CP20 (Consolidated Supervision)	See Supervisory Techniques above.
25	Home-Host Relationships	Establish formal relations with foreign supervisors, including through MoUs—2006 CP25 (Supervision Over	Propose protocols for signing MoU with FMA of Austria, possibly via CBBH or based on MoU to be signed with Bank of

		Foreign Banks' Establishments)	Italy.

<u>Part 2</u>: Current Status in 2008 re EU Directives and *Acquis Communautaire*

A. Overview re EU Actions in the Financial Sector

The European Union (EU) Directives and *acquis communautaire* in the banking and financial sector have reconciled with international initiatives since the original Basel Capital Accord of 1988. (A summary of key underlying principles in the financial sector for access to the EU are included in Appendix 3.) The main original directives included the Solvency Ratio (89/647/EEC) and Own Funds (89/229/EEC), effectively mapping out the rules for EU banks' capital requirements. Since then, the EU has adapted a number of key directives to influence developments in the banking and securities markets and to prepare for the implementation of Basel II. Some of the key original directives during the Basel I period include:

- Deposit Guarantee Schemes (94/19/EC)
- Capital Adequacy Directive (93/6/EEC)
- Large Exposures Directive (92/121/EEC)
- Solvency Ratios Directive (89/647/EEC)
- Second Banking Directive (89/646/EEC)
- Own Funds Directive (89/229/EEC)
- Disclosure Requirements of Foreign Branches Directive (89/117/EEC)
- Capital Liberalization Directive (88/361/EEC)
- Bank Account Directive (86/635/EEC)
- Consolidated Supervision Directive (83/350/EEC)
- First Banking Directive (77/780/EEC)

More recently, the EU Commission for an Action Plan on Financial Services provided direction for new rules to be consistent with Basel II, effectively launched EU-wide on January 1, 2007. Directives have also brought Europe in line with principles in the insurance and securities markets as articulated by the International Association of Insurance Supervisors (IAIS) and the International Organization of Securities Commissions (IOSCO). Some of the more important recent banking and securities directives include:

- Business of Credit Institutions (2006/48/EC)
- Capital Adequacy of Investment Firms and Credit Institutions (2006/49/EC)
- Money Laundering and the Financing of Terrorism (2005/60/EC)
- Financial Conglomerates (2002/87/EC)
- Financial Collateral (2002/47/EC)
- Market Abuse (2002/__/EC)

The <u>Capital Requirements Directive</u> is one of the two most important EU directives in the banking sector, and is effectively comprised of two sub-directives pertaining to Credit Institutions and Capital Adequacy of Investment Firms and Credit Institutions. The purpose of Directives 2006/48/EC and 2006/49/EC is to ensure the financial soundness of credit institutions ("banks") and investment firms, thereby providing the framework for day-to-day prudential supervision of these institutions. This directive is consistent with Basel II and puts the measurement of regulatory capital on a more risk-adjusted basis than found in the earlier Basel Capital Accord framework. As of mid-2008, the EU anticipated making modifications to the Directive to further address large exposures, hybrid capital instruments, supervisory arrangements, and adjustments to some of the technical provisions in the Directive.

The Financial Conglomerates Directive and corresponding banking legislation are, along with the Capital Requirements Directive, the most important pieces of legislation in the EU with regard to the banking sector. The Financial Conglomerates Directive primarily corresponds to Basel II requirements for large-scale universal banks and diversified financial conglomerates (including insurance and securities markets firms), which are typical in Europe. Along with national banking legislation, the Directive serves as the key policy instrument in the EU for the open market in banking and financial services. This Directive introduces specific legislation for the prudential supervision of such financial conglomerates, and more broadly large financial groups that are important to the stability of the financial system. The main objectives of the Directive are:

- Ensuring that financial conglomerates are adequately capitalized. In particular, the rules under this Directive prevent the same capital being double-counted or being utilized as the same capital base against a broad array of risks characteristic of financial conglomerates. In other words, this Directive prevents conglomerates from "multiple gearing" of its capital base, and thereby seeks to ensure that each of the conglomerates' financial businesses is adequately capitalized on an unconsolidated basis. The Directive also prevents "down-streaming" by parent companies whereby they issue debt and then use the proceeds as equity for their regulated subsidiaries ("excessive leveraging").
- Introducing methods for calculating a conglomerate's overall solvency position.
- Dealing with issues of intra-group transactions, exposure to risks, and the suitability and professionalism of management at the financial conglomerate level.
- Ensuring adequate internal control mechanisms and appropriate risk management processes are in place and tested in a conglomerate.
- Enhancing effective group supervision across financial sectors and borders. This is facilitated by requiring EU Member States to ensure that one single authority is designated responsible for the oversight of each financial conglomerate, and to ensure coordination between the different supervisors involved in the supervision of a financial conglomerate's component parts.
- Removing unnecessary inconsistencies between the regulations for homogeneous financial groups and for financial conglomerates to ensure a minimum of equivalence in the treatment of these groups.

The Market Abuse Directive largely corresponds with many of the IOSCO principles that focus on investor protection, market fairness, efficiency and transparency, and general systemic stability. The objective of the Market Abuse Directive is to ensure fair, orderly and participatory European financial markets that are secure and more attractive for investors. The provisions of the Directive include:

- Establishing and maintaining high standards for market integrity.
- Contributing to the harmonization of rules for market abuse throughout Europe.
- Establishing a strong commitment to transparency and equal treatment of market

participants.

- Requiring closer co-operation and a higher degree of exchange of information between/among national authorities, thus ensuring the same framework for enforcement throughout the EU and reducing potential inconsistencies, confusion and loopholes.
- Treating incidence of insider dealing and market manipulation by ensuring that the same framework would be applied for both categories of market abuse.
- Requiring each Member State to designate a single administrative regulatory and supervisory authority with a common minimum set of responsibilities to tackle insider trading and market manipulation.

The Market Abuse Directive covers all financial instruments admitted to trading on at least one regulated market in the European Union, including primary markets. The Directive applies to all transactions concerning those instruments, whether those transactions are undertaken on regulated markets or elsewhere. This is to avoid unregulated markets, alternative Trading Systems, and others being used for abusive purposes concerning those financial instruments.

These directives are consistent with Basel II, and build on earlier rules that were consistent with the original Basel Capital Accord. In some cases, such as the Market Abuse Directive, the scope overlaps with IOSCO and is less central to banking supervision. Nonetheless, **to the extent that the supervisory agencies in BiH do not comply with the BCPs or the features described above, they do not comply with EU directives**.

B. Current EU Plans to Strengthen Banking Supervision in BiH

The European Union carried out a needs assessment for the Central Bank of Bosnia-Herzegovina to determine assistance that could be provided in the coming years to contribute to the EU integration process.[9] Findings and recommendations from this assessment were presented to CBBH March 20, 2007. It is within this context that specific plans and recommendations to strengthen the banking supervision function in BiH were made. Progress has been reported on some of the proposed actions and recommendations, namely statistics, economic analysis research, and financial stability. In banking supervision, there has been marginal progress, mainly involving enhanced coordination between the Agencies and CBBH with more regular meetings to discuss financial stability-related issues and for increased data and information exchange. However, as noted above, the entity-level approach to banking supervision remains a point of contention between the EU and BiH, and this has slowed activity under the program.

Rather than a step-by-step assessment of current BiH banking supervision practices and how they may deviate from EU Directives or *acquis communautaire*, let alone BCPs, **the EU evaluated broad gaps at the macro and structural levels that CBBH should attend to as a basis for strengthening its role in seven functional areas**:

- Economic Analysis and Research
- Statistics
- Monetary Policy (under a CBA)

[9] See "CARDS Programme for the Central Bank of Bosnia and Herzegovina—Needs Analysis", European Union, March 20, 2007.

- Payment and Settlement Systems
- Financial Stability
- Coordination of Banking Supervision
- Internal Audit

Key findings from the assessment of banking supervision included:

- **The current decentralized, dual-entity approach to banking supervision is "sub-optimal"** in terms of efficiency, effectiveness, and ultimate compatibility with the requirements of EU membership. This position is strongly at odds with prevailing viewpoints in Republika Srpska.

- **There are no real benchmarks for the EU to utilize** within the 27-member community due to the single-entity approach adopted by EU member states. Such issues would be expected to complicate future discussions of EU *membership*, although they should not be impediments to ongoing EU *integration* in the coming years.

- **There are many gaps in the overall recommended EU framework for effective banking supervision**. While operational capacity has been strengthened over the years at both agencies as a result of technical assistance from USAID, the focus of the EU on the role of the CBBH determined that there were substantial institutional gaps at CBBH regarding the implementation of effective supervision. This is partly the result of a comparatively weak central bank legal mandate in the field of supervision that the EU (and other parties) believes should be strengthened, particularly due to the linkages to financial stability and other areas of focus that are the mandate of the central bank.

- **The coordinating role of the CBBH in the area of banking supervision should be strengthened to build on what are currently good relations between the two banking supervisory agencies**. This can be done by expanding the role of CBBH as currently defined in the Memoranda of Understanding with the respective agencies, dedicating resources and personnel to these tasks, and considering establishment of a Coordinating Unit within CBBH in the medium-term.

In many cases, the EU recommendations focus on increasing the role of the CBBH in the banking supervision process within the larger context of increasing capacity and information for the CBBH to more accurately monitor risks to financial stability. Thus, current EU recommendations do not specifically address issues of a single regulator on a State-wide level.[10] However, the involvement of CBBH as a state-level institution suggests the EU is proposing to support CBBH in a manner that would permit it to either become the primary institution responsible for banking supervision over time, or to provide it with the kinds of capacity enhancements needed for it to more effectively communicate and cooperate with a separate state-level regulator or set of regulators in support of CBBH's focus on financial stability. In some cases, recommendations relate directly to BCPs, such as provisions regarding credit and liquidity risk, supervisory reporting, supervisory techniques

[10] The EU position remains open about how to implement State-level supervision in financial services, but State-level institutions remain an essential condition and priority for movement forward in the partnership and eventual potential for membership of BiH in the EU.

(e.g., off-site surveillance, on-site examinations), and coordination and cooperation with other supervisory agencies (domestic and cross-border).

Specific recommendations for improved coordination of banking supervision over the next several years are summarized in Appendix 4. These include:

- Better information of the CBBH on banking supervision issues.
- Setting up a Main Indicator table for the CBBH Management Committee.
- Implementing MoUs with main home foreign supervisors and developing cooperation with other BiH financial supervisors.
- Exchanging information with the banking industry and all parties involved in bank audits.
- Providing CBBH with information on banks' liquidity.
- Providing CBBH with information on banks' potential problems.
- Setting up emergency procedures for crisis situations.
- Implementing a consultative procedure of CBBH prior to enforcement sanctions by the agencies.
- Implementing a consultative procedure of CBBH prior to the issuance of any draft regulations by the agencies.
- Implementing a common human resource policy.
- Setting up common administrative functions.
- Implementing a common supervisory disclosure policy.
- Identifying differences in call reports and regulations, and revising them for consistency with EU standards.
- Implementing a common off-site monitoring methodology.
- Implementing a common methodology for the agencies' on-site examinations and remedial actions.

Additional initiatives at the CBBH level that should help the banking supervision function in BiH meet EU standards and requirements, directly or indirectly, include:

- **Enhanced economic research should provide the agencies with a better framework for risk-based analysis (recommendations A2-A4)**. While the data specified by the EU are not primary concerns of the agencies, refinement of the specified data and the research associated with them will help the agencies with their assessment of real sector and macroeconomic developments that can influence banks' performance.

- **Improved statistics regarding banks' financial statements as well as investment funds, insurance companies, leasing companies and other financial sector institutions will help with the overall assessment of stability (recommendations B2-B7)**. Specific to banking supervision, such statistics will help as financial institutions diversify and become more complex. Such statistics may eventually also help to advance the framework for consolidated accounting and reports to assist with eventual consolidated supervision. This will also assist the banking agencies in their coordination with other supervisory agencies—banking and non-banking, domestic and cross-border.

- **Efforts to strengthen CBBH independence would eventually help to strengthen**

banking supervision independence should the functions/institutions be merged at some point (recommendation C1). At a minimum, efforts to strengthen CBBH institutional and personal independence may help to set standards for additional protection for the respective supervisory agencies that would move them closer to full compliance with BCP #1 regarding independence.

- **Introduction in CBBH of a domestic money market and collateral market along with a government securities market will foster improved liquidity management techniques and potentially serve as a catalyst for greater inter-bank lending (recommendations C5-C6, D8-D11)**. These can help and complicate the banking supervision function, depending on relevant risks. They also point to gradual diversification, expansion and complexity of activities undertaken by banks in the coming years. In general, developments in this area should help the agencies with a better macro-prudential framework that supports financial stability, and makes it more feasible to manage credit, market and liquidity risks.

- **Advancements in the legal framework for payments and settlements will assist with operational risk management issues (recommendations D13-D16)**. As BiH banks are generally only at the beginning of the Basic Indicators Approach to operational risk management (under Basel II), advances in these functional areas will help the agencies better coordinate on money laundering and related financial crimes, as well as plan for a more electronically-driven system that will enhance financial sector and economic efficiency. Efforts in this area will also help with coordination efforts with other bodies on securities-related matters and payment/settlement issues, as well as help with contingency planning under crisis situations.

- **Initiatives taken to promote financial stability will help to reinforce stable banking (recommendations E1-E5)**. The challenge to the agencies will be to build on existing foundations for stability while promoting greater innovation and risk-taking to more fully advance the banking system. In general, the initiatives proposed by the EU will help the agencies develop capacity to discharge their duties. This includes the enhancement to existing data that will make it more feasible for the agencies to conduct scenario analyses to test for risk, as well as the larger effort by CBBH to conduct stress tests to test for challenges to the macro-economy.

Part 3: Current Status in 2008 re IOSCO Principles

A. General Overview

This particular component of the report reviews IOSCO-related aspects of the financial market to future movement towards effective risk-based supervision in the banking sector. There is currently virtually no exposure of the banking system to the securities markets.

The general detachment of banks from the capital markets in BiH indicates there are currently no significant capital markets issues to be dealt with from a supervisory perspective. Bank balance sheets show total securities investments at KM 58.6 million as of year-end 2007, only 3 percent of total banking assets. Thus, from an assets and earnings perspective, there is little exposure to or reliance on the capital markets by the banks. Likewise, 62 percent of banks' liabilities are deposits, with the remaining funding sourced from loans (mainly from parent banks abroad), 26 percent of total liabilities, and capital, at 13 percent of total liabilities.[11] Thus, banks do not rely on the capital markets for funding. The limited inter-bank market also shows very limited reliance on banks or other markets for liquidity management.

On the other hand, as banks are gradually permitted to increase their exposures and seek funding from the capital markets, risk issues will emerge. As such, it is essential that the capital markets meet the conditions for soundly functioning markets in the future so that risks can be properly identified, measured, monitored and managed. This will be essential to the banks' own capacity to develop sound risk management systems, particularly in areas such as market and operational risk that will be developed in the coming years. Likewise, exposures to investments and firms listed on the exchange will change the nature of how banks currently assess credit risk and structure and manage their portfolios. In addition, while banks have been compliant with Liquidity Risk BCPs since the 2006 assessment, systems will need to be upgraded should liquidity management requirements change in the coming years.

A broader review of IOSCO principles and a cursory assessment is summarized in Appendices 5-6 as part of the questionnaire responses.[12] More specific to the issues of risk-based supervision in the banking sector are the following:

- Discussion of the three key objectives, and how they impact developments in the banking sector.
- Preconditions for effective securities regulation, namely the macro-prudential setting and corresponding infrastructure and regulatory environment.
- Status of the securities regulator as a counterpart for risk-based supervision.
- Capacity for self-regulation and potential impact on financial stability.
- Enforcement of securities regulation and potential impact on the banking sector.
- Cooperation in regulation domestically and internationally, with particular focus on financial conglomerates and cross-border transactions.
- Issuers and their impact on banks' earnings, funding and capital.
- Collective investment schemes and their impact on banks' earnings, funding and capital as well as operational and broader risk management issues.
- Market intermediaries and their impact on banks' earnings, funding and capital as well as operational and broader risk management issues.
- The secondary market and its impact on banks' earnings, liquidity, funding and capital as well as operational and broader risk management issues.

B. Current Status in the Federation

Based on information from the Securities Commission and Sarajevo Stock Exchange (SASE), the Federation meets many of the IOSCO preconditions for effective securities markets. There is an adequate legal and regulatory framework in place that sets guidelines

[11] Figures calculated from "Bulletin 4", CBBH, December 2007.
[12] In the case of the IOSCO-specific questions, these were discussed with the RS Securities Commission, while the Federation Securities Commission filled in answers manually to the questions in the questionnaire and transmitted them electronically. By contrast, the banking supervision agencies responded to all the questions related to banking supervision and the BCPs manually. These were subsequently discussed, as were topics related to existing and future securities market exposures and associated risk issues for the banks.

for the issuance and trading of securities and clarifies the roles of various institutions and market players.[13] The legislation also includes accounting and disclosure requirements in support of transparent markets, including in the area of takeovers and substantial shareholders. Investor protection rules include provisions on inside information and the manipulation of prices. Though the legal regulations on Securities and Penal Code provisions are not as detailed as IOSCO regulatory standards, they do cover major situations of price and market manipulation (i.e., preferential information usage). As such, they offer a sufficient basis for protection of investors' interests. Likewise, the capital market in FBiH is fair, as regulations apply to all participants. A regulatory basis for transparency exists and is applied to the extent possible. However, Parliamentary procedures for making/amending laws are slow and perceived by regulators to be ineffective. This makes conditions for capital market regulation difficult.

The Securities Commission of FBiH is an independent institution established in 1999 to regulate, approve and supervise the issuance and trading of securities in the Federation market. Its mandate is to protect investors and develop the capital markets by authorizing and supervising public share offerings, brokerage services and companies, trading, and the operations of both SASE and the Securities Registry. The Securities Registry, also founded in 1999, performs registration, safekeeping and maintenance of data on securities, and operations of transfer, clearing and settlement.

Supervision of securities regulation regarding detection and investigation has been effective so far, along with the Commission's primary measures. However, court proceedings on offenses and criminal liabilities are slow and ineffective, rendering sub-optimal results. The influence of banking supervision is effective to the extent that the banks are involved in market transactions.

The Sarajevo Stock Exchange (SASE) is a self-regulatory entity composed of 18 broker members. SASE has 40-50 listed companies that show comparatively regular trading activity on the main "official" exchange. The official market accounts for 29 percent of trades, mostly (20 percent) investment funds. The balance of listings (71 percent) trades on the "free market". Issuers in BiH are mainly companies that emerged from the privatization process. The participation of these companies on the primary market (as an alternative to bank loans) has been limited to date.

Turnover has risen steadily in recent years, with 2007 turnover (KM 1.3 billion) more than 30 times levels in 2002. However, by global standards, turnover figures are low. There are no free float requirements for issues on the main SASE exchange.

Banks are not major issuers. ABS Banka turnover was second among issuers in 2007. However, no other bank was listed among the top 10 issuers in terms of turnover. Three member banks—Raiffeissen, Hypo-Alpe Adria, FIMA—were ranked first, fourth and sixth among brokerages in terms of turnover in 2007, accounting for more than half of turnover. Data on market capitalization of banks or how these figures relate to bank capital were not available.

[13] Key legislation in FBiH includes the Law on Securities Commission, Law on Securities, Law on the Securities Registrar, Law on Funds Management Companies and Investment Funds, Law on Business Companies, and Law on Company Takeovers.

Due to the limited exposure of banks' activities in the securities markets, there is little if any systemic risk currently posed. In the Federation, banks' securities holdings totaled KM 48.6 million, only 0.3 percent of assets and 3.2 percent of banks' capital at the end of 2007. There is no derivatives market, and the FBA does not believe off-balance sheet items for Federation banks carry any major risk exposure to securities markets.

Closed investment funds in FBiH have been transformed into privatization funds that actually were transitional tools in the privatization process. Regardless of their size, their impact on the banking sector (as an investor or lender) is very limited. Efforts to form open mutual funds have recently been identified as a potential alternative to bank savings instruments, but these funds by size (financial capacity) are not very important compared to the banking sector.

Banks are potentially active as issuers, market intermediaries, and through collective investment schemes, although current levels of activity are low. As noted, three banks currently account for three of the largest six brokerage firms trading on the exchange. However, gross earnings from securities market activities by the banks in the Federation were not made available, and are thought to be relatively low by European and even some regional standards. Gross operating income net of service fees and foreign exchange income was KM 96 million in 2007, but this does not specify income derived from securities trading.[14] This suggests a low level of activity in the capital markets for the banks.

The Securities Commission has not entered into formal MoUs with the banking supervision agencies in BiH. However, it is anticipated that both entity Securities Commissions will be part of larger efforts in BiH to coordinate information exchange in the interest of market stability. In this regard, the Federation Securities Commission should become increasingly important over time as a counterpart for risk-based supervision. Moreover, all the regulators in banking and securities claim that coordination is fine in the absence of MoUs. Preparations for integration into a Multilateral Agreement on Exchange of Information with other member commissions to IOSCO are in progress, which will further extend current cooperation on a cross-border basis when the agreement takes effect.

The Federation Securities Commission and SASE actively seek foreign investment into the market. In this regard, the Securities Commission is a willing partner to ensure cooperation in regulatory oversight as needed for financial conglomerates and cross-border transactions as necessary.

There is limited secondary market trading in the Federation. Most companies trade on the free market, but these companies generally do not have the same level of information disclosure as those listed on the official exchange.

C. Current Status in Republika Srpska

Based on data from the RS Securities Commission (RSSC) and Banja Luka Stock Exchange (BLSE), some of the preconditions are in place for effective functioning of the

[14] Based on earnings figures as reported by FBA for 2007. SASE reports that brokerages routinely charge 1.0-1.5 percent of trade value as commission. Applying the mid-point, 1.25 percent, to total 2007 turnover on SASE would have produced about KM 16 million in commission income. As banks account for only three of 16 brokers, it is unknown what the banking sector's share is. However, as noted, income figures from non-interest sources are low in both the Federation and RS.

securities markets. There is an application in process with IOSCO for a multilateral agreement that would provide the RSSC with an umbrella agreement with other securities commissions. New legislation adopted in 2006 seeks to provide adequate protection for investors, and is modeled on EU principles and directives.[15] A new Companies Law is planned for 2008, which is also expected to strengthen the framework for securities market development. Institutional infrastructure is in place for clearing and settlement of transactions, handled electronically via an account at the CBBH. The RSSC oversees the central registry of firms listed on the exchange. Transparency is strengthened by the BLSE information portal for companies, including their financial information as well as trading and capitalization data. Shareholder education is intended to help with corporate governance.

The capital markets show an adequate number of market players to help the markets function effectively. This includes 17 brokerage firms, 15 management companies, 17 investment funds, 5 custodian banks, 3 depository banks, 45 licensed stock brokers, and 51 licensed investment managers.

Banks are potentially active as issuers, market intermediaries, and through collective investment schemes, although current levels of activity are low. The banks active in brokerage business accounted for about KM 1.13 billion in total turnover, about 76 percent of total for the exchange in 2007. Banks currently account for seven brokerage firms, one management fund, one investment fund, three custodian banks, three depository banks, seven licensed stock brokers, and three licensed investment managers. However, gross earnings from securities market activities by the banks in RS were only KM 8.5 million in 2007.[16] This indicates a low level of activity in the capital markets for the banks, even if they account for most of the turnover activity as brokers.

Banks do not currently look to the BLSE as a source of funding. Only two banks are listed on the BLSE official exchange, while most others are listed on the free market. Only one bank (Nova Banja Luka Banka) issued shares in 2007,[17] while two banks issued bonds (NLB Razvojna and Balkan Investment).[18] Together, turnover in these securities was less than 0.02 percent of BLSE turnover in 2007.

While turnover has increased steadily since 2002, the BLSE shows little secondary market trading, and most listed companies do not trade on the official market. As of early 2008, the BLSE showed 848 listed companies. However, most of these are linked to past voucher privatization. Only 33 of the 848 companies trade on the official market. Total turnover in 2007 was KM 743 million, of which free market shares accounted for about half, followed by Privatization Investment Fund shares (34 percent) and then official exchange shares (17 percent). None of the banks were among the most actively traded shares in 2008.

Ongoing challenges and weaknesses are partly related to a lack of market development, the need for reforms in the real sector, and the lack of confidence (or knowledge, awareness, resources and experience) of much of the public. Many of these issues are

[15] Key legislation in effect in RS for securities market operations includes the Investment Funds Act (2006), Securities Market Law (2006), Law on Takeovers (2002), Law on Privatization Investment Funds and Privatization Fund Companies (2000), and the Law on Enterprises (1998).
[16] Net earnings figures from securities trading were not available. See "Information on Republika Srpksa Banking Sector Condition—As of December 31, 2007", RSBA, March 2008.
[17] This was valued at KM 476,949, or 0.06 percent of BLSE turnover in 2007.
[18] Total value of bond turnover in 2007 was KM 818,005, or 0.11 percent of total turnover.

expected to be sorted out in the coming years, although it remains to be seen if such a small market will be viable in the long run. RS faces the challenge that many other small jurisdictions face: lack of scale, small number of firms that qualify for first-tier markets, etc.

As with banking supervision, there may be recommendations from the EU and other parties to encourage securities regulation to become a State-level function rather than an entity-level function. RSSC is committed to cooperation domestically and internationally, similar to the commitment shown by RSBA in its coordination with the FBA and CBBH on banking supervision matters. However, as banks become more integrated with and exposed to the securities markets, there may be calls by the EU to consolidate the securities market regulatory functions into one centralized agency at some point in the future.

The market would likely benefit from specific free float requirements over time. While listed firms might currently object to such a requirement (e.g., minimum 25 percent of listed shares), such requirements would likely induce a greater sense of investor confidence and help to reduce some of the liquidity constraints in the market. As noted by the RSSC, secondary market activity is limited in RS, and only 33 shares trade on the "official" exchange.

There is virtually no systemic risk potential at the moment for the banks. This is more a function of detachment and lack of involvement by the banks in the securities markets. At the same time, this can be expected to change in the future as banks are gradually permitted to increase their exposures and activities in the securities markets.

The RSSC has some of the capacity needed to assist with risk-based supervision of the banks in the future. At the moment, there is little risk in the market, and only a small government securities market (entity level) based on bond issuance at the municipal level. However, the Commission will need help in several areas related to Basel II implementation. They will also need help in areas of insider trading and connected party transactions, as well as future development of a State-level government securities market.

Some capacity for self-regulation currently exists with the BLSE. However, any movement towards risk-based supervision of the banks will need to involve regulators as well as market players.

To date, enforcement of securities regulation is not reported to be a problem. To the extent that the court system has proved to be inefficient or unreliable, some of this is changing as judges are trained in commercial law to help settle disputes. In any event, banks have been able to avoid such issues as their exposures are limited. However, issues could potentially emerge in the future should defaults rise.

D. Current Plans for IOSCO-Related Activities in the Banking Sector and Potential Impact on Banking Supervision

The banking supervision agencies have not developed detailed plans or programs for IOSCO-related activities or their impact on the banks, although they are seeking to arrive at multilateral agreements via IOSCO. In both entities, the banks are permitted to engage in brokerage and trading activities on the exchanges. However, as noted, there is limited activity as of now by the banks in BiH securities markets.

The EU CARDS program anticipates more information exchange on securities markets and better coordination and cooperation among the various regulatory agencies involved in banking and securities markets. This was projected for achievement within a 1-3 year time horizon from the start of the program (in 2007). Data exchange is currently in process regarding brokerage operations. The agencies have also stated they plan to sign MoUs with the Securities Commissions in 2008, and this will enhance coordination and cooperation.

While the banking agencies have not focused on the securities markets, there will be scope for increased attention as supervisory issues emerge. Future development and complexity of the financial system will require that the supervisory agencies increase capacity to monitor for potential risks to banking system safety, soundness and stability. The possibility of an active government securities market will help the banks with liquidity and risk management, trading/hedging, etc. and will not pose a serious risk issue for the supervisors. However, over time, as banks become more active in equity and bond markets, as well as introduce derivatives in various forms, there is likely to be a need for closer supervision.

The Securities Commissions anticipate priorities in the next few years to include:

- Ratification of multilateral agreements on the exchange of information via IOSCO.
- Preparations for EU integration and eventual accession.
- Upgrades of IT, hardware, software, and staff training.
- Strengthened standards for corporate governance.
- Possible development of a government securities market.
- General efforts to increase market activity, including liquidity in the secondary markets.

FINDINGS & RECOMMENDATIONS

Part 1: Implications of Mid-2008 Gaps on Banking Stability

There is practical recognition by the two supervisory agencies of prominent risks they face in the banking system, as well as anticipation of future risks as the system evolves and eventually becomes more complex. Key issues include:

- **Credit risk is generally well contained, but there are still problems associated with loan classification, loan loss provisioning, and the absence of consolidated accounts**. There are continued issues of governance, management and information disclosure in the real sector, all of which can undermine asset quality for the banks. Likewise, in an increasingly competitive and saturated market, lenders often ease up on underwriting standards in an attempt to gain market share. This may generate future challenges to the system, particularly as BiH's large-scale corporate sector is relatively small. Finally, the surge in long-term lending to consumers potentially carries risks to the extent that there is a broad downturn in the economy that translates into higher default levels by households on their loans. (The RS noted this is a concern, as many of the loans being made by banks are not considered "productive", and instead are being used to finance consumption.)

- **Market risk is a relatively new area for many BiH banks**. To some degree, the banks have been shielded from much of this risk by virtue of the currency board regime, in place since 1997. However, it is expected that banks will want to pursue other lines of business that involve increased market risk than they have faced in recent years. This includes increasing foreign exposures via more active involvement in trading and investment in foreign currency-denominated securities (for their own account as well as on behalf of clients), re-pricing risk (e.g., about three quarters of loans are long-term and less than half of deposits are time/savings deposits exceeding one year; potential future risk of exchange rate to the euro), and exposure to derivatives and hedging tools (e.g., forwards, futures, options, swaps).

- **Operational risk is a clear challenge in BiH, as it is a relatively new area that was not well developed under the original Basel Capital Accord**. Under Basel II, basic operational risk is covered under the Basic Indicators Approach that applies a 15 percent capital charge on gross income.[19] This is a simple formula and is applied when banks are not yet in a position to pursue the standardized approach that applies capital changes to eight lines of business within a range of 12-18 percent of gross income. In BiH, banks will need to introduce or reinforce systems that protect against the risk of fraud, systems failure, data vulnerability, legal risk, etc. BiH has already begun to address some of these issues in its efforts to implement Know-Your-Customer, establish an International Bank Account Number (IBAN), and coordinate via CBBH and others regarding suspicious transactions. However, even the simplified approach recommended under Basel II is new for BiH (and most countries), and this will add to the challenge of working through other systems-related issues that already

[19] Gross income is defined as net interest income plus net non-interest income, and specifically excludes profits/losses from the sale of securities and any extraordinary income (e.g., one-time gains, insurance income). Thus, a capital charge of 15 percent against total gross income would be applied on a rolling three-year basis based on the previous three years of results.

remain a challenge for at least some of the banks.

- **The Agencies do not supervise based on <u>consolidated accounts</u>**. This suggests that some of the banks may have exposures or risky positions via related parties or companies that could serve as a risk to the underlying financial condition of the bank itself. For instance, banks that are parts of larger conglomerates may be utilized as a source of working capital or investment financing that is not allocated on sound commercial grounds. In general, credit risk is adequately supervised based on existing information. However, as real sector enterprises often do not prepare consolidated accounts, the banks are exposed to unknown risks that would be at least partly disclosed through consolidated accounting practices.

- **<u>Future complexity</u> is expected as banks diversify their operations**. Given the low return ratios for banks in BiH, as reflected by some of the lowest regional figures for return on average assets and equity,[20] it is expected that banks will diversify their operations to generate additional income sources, particularly fee-based, to improve returns. Likewise, banks will engage in other practices to help them hedge their risks related to interest rate, exchange rate, and general re-pricing risk. With such changes in the market risk composition of BiH banks' portfolios, greater capacity will also be needed for them to manage and monitor these risks.

- **An eventual <u>increase in exposures</u> of BiH banks outside of Bosnia-Herzegovina is anticipated**. While there is some external exposure,[21] this may change over time as trade and investment expand on a cross-border basis. At a minimum, expanded international trade will be accompanied by larger loan exposures as well as off-balance sheet items (e.g., performance guarantees) that will need to be accurately assessed for risk and potential losses.

- **The very <u>nature of supervision</u> will likely need to change over time from a two-entity approach to a more centralized and national approach linked institutionally to the CBBH, or perhaps as part of a larger unified financial services regulator**. The two-entity approach is rooted in the Dayton Accords. However, given the desire to eventually accede to the European Union, such a fragmented approach in such a small market is considered divergent from modern financial sector trends. Given consolidation and cross-ownership in the banking sector, such an approach may turn out to be costly and inefficient. At a minimum, it has been targeted for change by the EU. In the meantime, an enhanced coordination role by CBBH can serve as a vehicle for movement towards the implementation of Basel II under a dual-agency, entity-level approach to banking supervision.

[20] The IMF's Global Financial Stability Report (April 2008) shows a 0.9 percent figure for return on average assets (RoAA) as of September 2007. (According to data from the banking agencies and CBBH, RoAA in the banking sector in 2007 was 1.15 percent.) These figures are low by regional and international standards. For example, according to the same report, RoAA was higher than BiH in 20 of 22 countries grouped as part of Emerging Europe. Only the Slovak Republic reported a lower figure than BiH (June 2007), and their ratios have traditionally been higher than in BiH. Likewise, BiH banks had the lowest return on average equity (RoAE) figures in the region in 2007, even though RoAE has been increasing year to year since the early 2000s.

[21] As of December 31, 2007, 18 percent of banks' assets were foreign assets and 26 percent of banks' liabilities were foreign liabilities.

Both agencies noted that they need specific assistance to implement Basel II as they have limited or no experience with some of the more sophisticated aspects of the framework. This is particularly the case with internal ratings-based models, which are not likely to be put into effect any time soon except at the largest banks (e.g., Unicredit, Raiffeisen, possibly a few others). Other issues, such as securitization, credit derivatives, market risks associated with futures, options and swaps, advanced market risk simulation models and metrics, and Advanced Measurement Approach for operational risk should be deferred until a future point when fundamental aspects of Basel II are well in place.

<u>Part 2</u>: Recommendations for Effective Banking Supervision

1. General Approach

In light BiH history since 1995-96 and the development of banking supervision capacity, it is recommended that the agencies build on the existing CAMEL framework, adapt it to Basel II (e.g., add Sensitivity to Market Risk), and incorporate other enhancements and requirements based on the Basel II framework. Notwithstanding the ambitious plans of the agencies to implement Basel II and to be compliant with EU Directives, there is already a foundation on which to build a suitable model.

The agencies should take a gradual approach to implementation, recognizing a solid foundation will be needed before more complex forms of risk-based supervision are introduced. In some cases, this reflects limitations on the banks and supervision agencies. In other cases, it simply reflects weaknesses in external requirements (e.g., data for advanced modeling needed for Internal Ratings-Based systems or Advanced Measurement Approaches, land registry and use for secured transactions, role of outside appraisers).

The agencies should review Basel II components and develop a vision, strategy and action plan for what is expected to be a suitable framework based on how the banking system evolves over time. In this regard, the agencies should prepare for more complex, diverse financial institutions consistent with the "universal" model commonly found in Europe. The agencies will need to prioritize risks and resources/focus, focus on safety and soundness, and consider certain initiatives that will allow the agencies to efficiently manage the supervisory burden.

The agencies need regular engagement for sustained support. A qualified long-term advisor would be preferable, but this may not be feasible. As a result, USAID/PARE should try to supply regular assistance as needed on a demand-driven basis so that there is sustained support based on the priority needs of the agencies.

As a starting point, a workshop should be planned to produce a road map to Basel II compliance, essentially a vision and strategy/action plan for the key principles and requirements for design of a suitable Basel II framework for BiH. Key inputs should be a summary document on Basel II and relevant issues for BiH. Critical issues should be discussed and identified, and these should be the focus of near-term assistance for both agencies. The scope of the workshop should include coordination with CBBH, particularly with regard to its financial stability assessments, and EU Directives. Key output from this workshop should be the draft of the action plan that would detail how the agencies and relevant other institutions intend to proceed within the context of Basel II.

2. Role of the CBBH

The role of the CBBH and its ability to monitor a broad range of risks is critical to the underlying macro-financial stability of BiH. While the legal framework under the currency board regime limits the scope of its involvement in banking supervision, its powers to coordinate the respective banking supervision agencies is seen as essential in carrying out its responsibilities regarding monetary policy and financial stability. The USAID/PARE program should support the EU and other institutions supporting capacity enhancement in this domain. In particular, the program can help with areas where the EU CARDS program (and future programming) has been held up as a result of differing views on the entity-oriented approach to banking supervision in BiH. Specific areas of potential involvement can be identified by the CBBH, particularly as the financial stability assessment process evolves.

A key area of support that could be integrated into USAID's efforts to strengthen banking supervision would be to enhance the capacity of the supervisory agencies to utilize the findings from financial stability assessments for their own supervisory purposes. This can be done as part of the larger effort to link macroeconomic and financial stability issues of potential risk to the specific aspects of banks' capital, asset quality, earnings, liquidity management, and overall operations. Specific exercises would include capacity among supervisors to conduct scenario analysis and stress tests of specific bank portfolios based on existing or anticipated risks. This could and should be coordinated with CBBH as a structural component of larger financial stability assessments. In the meantime, for the supervisory agencies, this would transform their scope from traditional credit-oriented regulation and supervision to a broader macro-prudential focus that would account for the larger risks associated with the economy and how these interact with the presence of more diversified and complex banks.

3. Proposed Assistance for the Banking Supervisory Agencies

Core areas of focus and assistance should include:

- **Strategic planning for design and implementation of a suitable Basel II framework and timeline for BiH**. Background information on the Basel II framework and how this could be applied and implemented in BiH is needed. This includes all three pillars—(1) minimum risk-adjusted capital; (2) supervisory review; and (3) market discipline—encompassing multiple approaches regarding credit risk, market risk and operational risk. Background information should draw on relevant models that would be potentially of use to BiH for application over a roughly five to six year period. The action plan could also identify critical areas of support from or linkage to EU institutions to assist with the harmonization and integration process.

- **Training and additional assistance to make it easier for the banking system to comply with new guidelines on market risk**. The initial focus should include verification that guidelines issued are consistent with the Basel II framework. Training would include a review of Tier 3 methods recommended by the Basel Committee that have been adopted for standardized approaches. This would help the Agencies to develop capacity to monitor and manage exchange rate, interest rate and (re-)pricing risk as a part of larger market risk. This is a key priority as expressed by both agencies, and would help them address FSAP recommendations on strengthening capacity on capital adequacy and market risk.

- **Assistance with the introduction of consolidated accounting and supervision**. This will require translation of some accounting standards dating back to 2005, as well as focus on the structure, operations and finances of conglomerates (financial holding companies, bank holding companies, banking groups). This can include full consolidation methods, the equity method, and the proportional consolidation method. Capacity-building in this direction will help the Agencies supervise banks as they expand their activities in BiH to help diversify their earnings stream and increase their balance sheets. This will also help the agencies address several FSAP recommendations where movement to consolidated supervision was recommended.

- **Efforts should be made to strengthen coordination with the CBBH on financial stability issues**. The nature and complexity of banking supervision will change as the financial system develops. In addition to core Basel II issues to be adapted over time, the banking supervision agencies will benefit from enhanced knowledge of financial stability indicators and the linkages between macroeconomic and structural (microeconomic, banking-specific, and prudential) developments. This is important for all aspects of capital calculations (credit, market and operational risk), particularly as increased cross-border exposures and trade/investment are expected over time.

- **Coordination with the EU and Committee of European Banking Supervisors (CEBS) to ensure that BiH supervisory standards and practices are consistent with EU requirements for harmonization and convergence**. Initially, the focus should be on Basel II fundamentals. However, over time as integration deepens, there is likely to be increased focus on convergence. At a minimum, while focusing on methods to implement Basel II, the agencies will want to ensure they are following principles and practices consistent with European standards for effective supervision. This can be coupled from the outset with a focus on EU Directives noted above in the text to ensure regulations and supervisory practices are consistent with EU standards. In this regard, the recommendation focuses on technical aspects of supervision, and does not specifically address the issue of how banking supervision is organized within BiH.

- **Assistance should also focus on anticipated diversification and complexity of activities as the financial system evolves**. This will require increased familiarity with banking products/services, such as the implications involved for risk management and portfolio management. At a minimum, this could involve improved understanding of capital market products (e.g., money markets, bonds, equities), the role of derivatives and hedges, and fundamentals of securitization. In this regard, such capital markets-based activities will need to be understood from a risk management perspective. While entailing risks, such tools also provide banks with the means to manage liquidity as well as to diversify the earnings stream from their portfolios. However, in this regard, a clearer framework regarding securities and derivatives trading will need to be developed, with particular focus on how volatility can impact bank balance sheets, earnings, and liquidity and risk management. IOSCO-related guidance for securities markets can be part of the effort, and the agencies should plan to increase their coordination with securities commissioners to ensure that this process supports the agencies' supervisory requirements concerning capital adequacy, liquidity management, and credit and market risk management.

- **Work will be required in the implementation of appropriate accounting standards**. Particular emphasis can be focused on IAS 32 and 39 with regard to the financial reporting of complex financial instruments (IAS 32) and provisioning and general financial reporting (e.g., balance sheets, income statements) (IAS 39). As with provisioning and other similar challenges where regulations and accounting principles have not always been consistent, BiH will need to determine how practical applications of IAS 39 will affect the banks as a whole as well as on an individual basis. IAS 32 will need to be introduced in anticipation of gradual increases in the complexity of products and their valuations.

- **The agencies will need to work with the banks to ensure that loan classification is accurate**. With provisioning and loan loss reserve guidelines likely to be developed in 2008, it will be essential to validate that banks are not only following these guidelines, but are accurately classifying their loans in the first place. This may require additional targeted inspections with banks whose internal audit functions may not be considered sufficiently strong or autonomous.

- **Assistance should be provided to help with development of a clearer framework regarding country and transfer risk**. This should be developed according to Basel II, highlighting the role of external credit agencies and market discipline (pillar III) notwithstanding the current standing of the rating agencies in international markets.

- **The agencies should consider development of an information service to improve the public's understanding and importance of banking supervision with regard to deposit safety, banking system soundness, and consumer protection**. This would also be a key part of efforts to promote market discipline (pillar III) of the Basel II framework.

The following table presents a suggested list of Basel II-related topics that could serve as the basis for much of the ongoing effort described. In addition, and as noted in the CBBH discussion, these topics can be enhanced with other forms of training and assistance, including a better understanding of financial stability issues and their uses by supervisors in carrying out their mandate. As the global financial sector evolves, having capacity in this area will become more critical.

Table 5: Suggested Areas of Focus and Timeline for Risk-Based Banking Supervision

Topics	Addressed Needs*	Timeline
Capital and Basel II		
Pillar 3—Market Discipline	Basel II Framework	2009
Introduction to Operational Risk—Basic Indicators and Standardized Approaches	Operational Risk (BCP #15)	2009
Regulation of Market Risk	Market Risk (BCP #13)	2009
Introduction to Supervisory Validation	Supervisory Reporting (BCP #21)	2009-10
Regulation of Market Risk under the Standardized Approach	Market Risk (BCP #13)	2009-10
External Credit Risk Assessments	Capital Adequacy (BCP #6)	2009-10
Standardized Approach—External Credit Risk Assessments	Capital Adequacy (BCP #6)	2009-10
Risk Weight Formulas Under the Standardized Approach	Capital Adequacy (BCP #6)	2009-10
Pillar 2—Supervisory Review Process	Basel II Framework	2010-11
Simplified Standardized Approach	Capital Adequacy (BCP #6)	2010-11
Interest Rate Risk in the Banking Book	Interest Rate (Market) Risk (BCP #16)	2010-11
Introduction to Cross-Border Implementation of Basel II	Home-Host Supervision (BCP #25)	2011-12
Overview of Credit Risk Mitigation	Capital Adequacy (BCP #6)	2011-12
Credit Risk Mitigation—Guarantees and Derivatives	Credit Risk (BCP #8)	2011-12
Credit Risk Mitigation—Collateral and Netting	Credit Risk (BCP #8)	2011-12
Introduction to Internal Ratings-Based Systems	Basel II Framework	2012
Credit Risk		
Credit Risk in the Loan Portfolio	Credit Risk (BCP #8)	2009
Credit Risk Environment	Credit Risk (BCP #8)	2009
Supervisory Credit Classification	Problem Assets, Provisions and Reserves (BCP #9)	2009
Loan Loss Provisioning and Loan Loss Reserves	Problem Assets, Provisions and Reserves (BCP #9)	2009
Credit Approval and Administration	Credit Risk (BCP #8)	2009-10
Credit Analysis	Credit Risk (BCP #8)	2009-10
Accounts Receivable and Inventory Financing	Credit Risk (BCP #8)	2009-10
Country Risk	Country and Transfer Risk (BCP #12)	2009-10
Claims on Sovereigns and Government Entities	Credit Risk (BCP #8)	2009-10
Claims on Banks	Credit Risk (BCP #8)	2009-10
Claims on Securities Firms and Collective Investment Undertakings	Credit Risk (BCP #8)	2009-10
Commercial Loans	Credit Risk (BCP #8)	2009-10
Agricultural Loans	Credit Risk (BCP #8)	2009-10
Retail Credit and Consumer Loans	Credit Risk (BCP #8)	2009-10
Housing Loans	Credit Risk (BCP #8)	2009-10
Commercial Real Estate Loans	Credit Risk (BCP #8)	2009-10
Trade Finance	Credit Risk (BCP #8)	2009-10
Loan Grading and Credit Scoring	Credit Risk (BCP #8)	2009-10
Managing Problem Loans	Corrective and Remedial Powers (BCP #23)	2009-10
External Credit Risk Assessments	Credit Risk (BCP #8)	2009-10
Standardized Approach—External Credit Risk Assessments	Credit Risk (BCP #8)	2009-10
Loan Loss Provisioning—Types and Methodologies	Problem Assets, Provisions and Reserves (BCP #9)	2010
Credit Risk Components	Credit Risk (BCP #8)	2011-12
Overview of Credit Risk Mitigation	Credit Risk (BCP #8)	2011-12

Credit Derivatives—Types, Uses and Applications, Pricing, Credit Default Swaps	Credit Risk (BCP #8)	2011-12
Securitization Fundamentals	Credit Risk (BCP #8)	2011-12
Asset-backed Securitization—Credit Cards, Leasing	Credit Risk (BCP #8)	2011-12
Commercial Mortgage-backed Securitization	Credit Risk (BCP #8)	2011-12
Residential Mortgage-backed Securitization	Credit Risk (BCP #8)	2011-12
European Covered Bond Market	EU integration	2011-12
European Securitization Market	EU integration	2011-12
CDOs—Structures and Ratings	Credit Risk (BCP #8)	2011-12
Market Risk		
Regulation of Market Risk	Market Risk (BCP #13)	2009
Bonds—Government, Corporate	Market Risk (BCP #13)	2009-10
Equities	Market Risk (BCP #13)	2009-10
Commodities	Market Risk (BCP #13)	2009-10
Interest Calculations and Compounding	Market Risk (BCP #13)	2009-10
Present Value, Future Value, and Discount Factors	Market Risk (BCP #13)	2009-10
Math—Differentiation and Integration	Market Risk (BCP #13)	2009-10
Net Present Value, Internal Rate of Return and Reinvestment Risk	Market Risk (BCP #13)	2009-10
Bond Pricing and Yield to Maturity	Market Risk (BCP #13)	2009-10
Duration and Convexity	Market Risk (BCP #13)	2009-10
Forwards	Market Risk (BCP #13)	2009-10
Futures	Market Risk (BCP #13)	2009-10
Options	Market Risk (BCP #13)	2009-10
Swaps	Market Risk (BCP #13)	2009-10
Value at Risk	Market Risk (BCP #13)	2009-10
Standardized Approach to Regulation of Market Risk	Market Risk (BCP #13)	2009-10
Probability and Expected Return	Market Risk (BCP #13)	2011-12
Distributions and Confidence Levels	Market Risk (BCP #13)	2011-12
Volatility	Market Risk (BCP #13)	2011-12
Bond Strategies	Market Risk (BCP #13)	2011-12
Pricing and Contract Valuation of Forwards	Market Risk (BCP #13)	2011-12
Hedging and Trading of Futures	Market Risk (BCP #13)	2011-12
Arbitrage in the Futures Market	Market Risk (BCP #13)	2011-12
Valuation and Pricing of Options	Market Risk (BCP #13)	2011-12
Application, Pricing and Valuation of Swaps—Interest Rate and Currency Swaps	Market Risk (BCP #13)	2011-12
Operational Risk		
Introduction to Operational Risk	Operational Risk (BCP #15)	2009
Operational Risk Management	Operational Risk (BCP #15)	2009
Basic Indicators Approach	Operational Risk (BCP #15)	2009
Standardized Approach	Operational Risk (BCP #15)	2009-10
Preparation for Advanced Measurement Approaches	Operational Risk (BCP #15)	2011-12
* Addressed needs mention key or primary needs cited by the FSAP or other sources		
Sources: Topics derived from "Report on International Developments in Banking Supervision", BIS, September 2006		

POTENTIAL AREAS OF PARE STRATEGIC INTERVENTIONS TO ASSIST BANKING SUPERVISION AGENCIES

Task #1: July-August 2008

- Prepare summary of Basel II framework
- Prepare customized Basel II framework document for BiH accounting for existing status and gaps derived from the BCP Assessment (June 2008)
- Identify key issues for the banking supervision agencies to be discussed as part of the design of a suitable Basel II framework for BiH that will also serve as discussion points for the proposed September workshop

Task #2: September 2008 (workshop)

- Presentation of Basel II framework and pillars
- Presentation of financial stability aspects of banking supervision in anticipation of financial conglomerates and increased cross-border activities and exposures
- Implications of consolidated supervision and IFRS
- Discussion of country and transfer risk and implications for capital calculations
- Determination of priorities for Basel II implementation for each/both of the agencies
- Action plan document reflecting agreed strategy between the two supervision agencies, and showing links to coordination via CBBH re financial stability and country risk issues

Task #3: October-December 2008

- Prepare broad list of outstanding Basel II requirements for new legal and regulatory framework for BiH
- Draft possible new approaches to risk weight determination for capital calculations
- Identify reporting/systems requirements for more accurate risk-adjusted capital calculations by banks and supervisors
- Prepare summary of relevant EU directives to serve as a framework of principles for these tasks

Task #4: January-March 2009

- Identify changes to manuals needed for off-site and on-site supervision
- Submit list and proposed additions/revisions in manuals to peer review

Task #5: April 2009 (workshop)

- Discussions/workshop with bankers, leasing companies, other financial market players, CBBH, Ministry of Finance, Deposit Insurance Agency, Securities Commissions, Insurance Supervisor and auditors on results/outputs from Tasks #1-4

Other tasks to be identified at a later date.

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APPENDICES

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APPENDIX 1

Status of Recommended BCP Actions in the Federation from 2006 as of 2008

CP #	Principle	Recommended Actions	Actions Taken	Current Status
1	Objectives, Independence, Powers, Transparency and Cooperation	Strengthen corporate governance—2006 assessment = CP1.2 (Independence)		Still uncertain due to potential political interference.
		Amend secondary legal framework and ongoing supervisory practice—2006 assessment = CP1.3 (Legal Framework); Provide comprehensive legal protection and coverage of legal defense costs—2006 assessment = CP1.5 (Legal Protection)	The 2006 Amendment to Banking Law was adopted – for now it is compliant under the Law, but how the courts and prosecutors will interpret them remains unknown. Legal officials do not understand the functions and requirements of banking supervision operations.	
		Conclude MOU with the Security Agency—2006 assessment = CP1.6 (Information Sharing)	FBA collaborates with the Securities Commission informally when necessary.	Plans to sign MoUs with Securities Commission in 2008.
6	Capital Adequacy	Account for market risk, country risk, and transfer risk in capital analysis and requirements—2006 = CP6 (Capital Adequacy)	Market risk was regulated in 2007 and banks need to comply as of 12/31/2008. Preliminary mapping of capital charges related to ratings in process.	No action yet taken on country and transfer risk.
		Consult Rating Agencies regarding ratings for Government and CBBH obligations—2006 = CP6 (Capital Adequacy)	FBA does not consult ECAs. Usually banks do not extend loans to these state bodies and CBBH does not need them.	FBA is waiting to harmonize after implementation of Basel II framework.
		Establish capital requirements for other risks—2006 = CP13 (Other Risks)	In 2007 regulations on market risk were adopted (including interest rate risk in the trading book) and on operational risk.	Banks have to comply by 12/31/2008.
7	Risk Management Process	Issue specific standards for risk management that cover and better enforce interest rate, operational and systems risks—2006 = CP13 (Other Risks)	See above re Capital Adequacy.	See above re Capital Adequacy.
		Establish capital requirements for other risks—2006 = CP13 (Other Risks)	See above re Capital Adequacy.	See above re Capital Adequacy.
		Training should be	See above re Capital	See above re Capital

		increased and the guidelines for examination procedures for other risks should be incorporated into the On-Site Supervision Manual—2006 = CP13 (Other Risks)	Adequacy.	Adequacy.
		Supervisors require targeted training in the area of market risks—2006 = CP16 (On-site and off-site supervision)	See above re Capital Adequacy.	See above re Capital Adequacy.
8	Credit Risk	IT specialists to assess the reliability and accuracy of the information supplied by the banks related to lending—2006 = CP7 (Credit Policies)	The Agency's IT experts together with on-site controllers check data and harmonization of analytical records. Verification of accuracy of financial reports is done by external auditors.	Still not compliant.
9	Problem Assets, Provisions and Reserves	Revise definitions of loan categories and revise percentage of loan loss reserves—2006 = CP8 (Loan Loss Provisioning)	FBA is reviewing criteria for classification of loans and special reserve rates. Necessary analyses that will end with simulations including stress tests are being done. Agency approach expected to differ from FSAP recommendations, but be reasonably consistent with models used in many European markets.	FBA plans to adopt changes and amendments to the Agency's Decision on minimum standards for credit risk management and assets classification by the end of 2008 together with RSBA.
		Establish reserves for foreign currency-indexed loans—2006 = CP8 (Loan Loss Provisioning)	FBA has not revised definitions for classification of loans and reserve rate but analysis and preparations are being done.	Banks incorporate currency clause into loan agreements but not into the obligation part. Under the Decision on foreign currency position and FBA Instructions, banks have to keep open positions of individual currencies to not more than 20% of founding equity and the total open position to not more than 30%. This applies to assets and liabilities.
10	Large Exposure Limits	Analyze large exposures on a consolidated basis—2006 = CP9 (Large Exposure Limits)	FBA has made no progress.	FBA does not analyze directly on a consolidated basis at the banking group level. It has been done through assessments provided by external auditors because, under the Banking Law, a bank has to prepare reports on consolidated basis and

				auditors to audit them.
		Improve the quality of information required to evaluate collateral—2006 = CP9 (Large Exposure Limits)	FBA has determined the types and characteristics for prudent policies and procedures to evaluate collateral. FBA accepts the evaluation of authorized court appraisers and is not always satisfied with their appraisals. Non-existence of the market is the main problem.	Banks make effort to have realistic appraisals, but with an unregulated market it is not possible.
11	Exposure to Related Parties	Analyze connected lending on a consolidated basis—2006 = CP10 (Connected Lending)	No actions taken, and none needed.	Exposure of banks on individual basis and toward group of connected parties (beneficiaries) is done during on-site examinations taking into account every basis for connection. Compliant with BCPs.
12	Country and Transfer Risks	Issue a decision specifically addressing country risk—2006 = CP11 (Country Risk)	FBA has not issued a special decision.	No action taken specific to country risk.
13	Market Risks	Introduce capital charges for foreign exchange and other market risks—2006 = CP12 (Market Risk)	See above re Capital Adequacy. In 2007 FBA brought Decision on minimum standards for market risk management-management and capital requirements to cover risks: interest rates, currency, price, i.e. risk of own stock, and product and some other risks.	See above re Capital Adequacy. Comprehensive instructions for market risk have been developed. For the time being, only standardized approach to market risk is allowed.
		Supervisors require targeted training in the area of market risks—2006 = CP16 (On-site and off-site supervision)	Few seminars organized by FBA (engaged lecturers from Croatia) and some supervisors attended seminars abroad.	Training is insufficient and to date, inadequately described.
15	Operational Risk	Issue specific standards for risk management that cover and better enforce interest rate, operational and systems risks—2006 = CP13 (Other Risks)	In 2007 FBA brought Decision on minimum standards on operational risk management that defines requirements for additional capital based on all risks, internal and external with regard to procedural, errors, thefts, etc.	Re operational risk, banks' ledgers show these positions are still low and insignificant.
16	Interest Rate Risk in the Banking Book	Issue specific standards for risk management that cover and better enforce interest rate, operational and systems	See above re Market Risk.	See above re Market Risk.

		risks—2006 = CP13 (Other Risks)		
17	Internal Control and Audit	Issue specific standards for risk management that cover and better enforce interest rate, operational and systems risks—2006 = CP13 (Other Risks)	No, except that it is indirectly included into existing regulations on credit risk management and asset classification.	Existing standards insufficient.
20	Supervisory Techniques	Training should be increased and the guidelines for examination procedures for other risks should be incorporated into the On-Site and Off-Site Supervision Manuals—2006 = CP13 (Other Risks)	On-going training of supervisors in this period, but not enough re new risks. On-going efforts on harmonization of regulations and methods of supervision.	Guidelines, i.e. procedures for supervision of other risks are not incorporated into the on-site and off-site Manuals. Comprehensive manual for market risk has been prepared and provided to banks. Regulations are mainly harmonized and supervision is being performed in accordance with Supervision Manual designed by both Agencies.
		Supervisors should enhance their expertise in verifying the accuracy of financial statements and management information—2006 = CP16 (On-Site and Off-Site Supervision)	The Agency's IT experts together with on-site controllers check data and analytical records. Verification of accuracy of financial reports is done by external auditors as well as by FBA supervisors.	Supervisors have necessary expertise in verifying financial statements. When it comes to reserves for loan losses they correct external auditors' findings, and sometimes it impacts on profit-loss. Problems re classification, provisioning, and IAS 39.
		Supervisors require targeted training in the area of market risks—2006 = CP16 (On-Site and Off-Site Supervision)	See Market Risk above.	Additional training is planned.
		Supervisors should collect, review and analyze reports from banks on a solo and consolidated basis—2006 = CP18 (Off-site Supervision based on Bank Reports)	See Large Exposure Limits above.	Not compliant. Work is needed in this area, particularly as banking legislation follows a universal model.
21	Supervisory Reporting	Supervisors should collect, review and analyze reports from banks on a solo and consolidated basis—2006 = CP18 (Off-site Supervision based on Bank Reports)	See Supervisory Techniques above.	See Supervisory Techniques above.
		IT specialists who can assess the reliability and accuracy of the information supplied by the banks in the loan area required—2006 = CP19 (Validation of Supervisory	See Supervisory Techniques above.	See Supervisory Techniques above.

		Information)		
		Formally define qualifications of external auditor, and grant FBA the power to revoke an auditor's license—2006 = CP21 (Accounting Standards)	Decision on minimum standards of internal and external audit has defined responsibilities and qualifications of external auditors. In addition, every year, without prior written approval by FBA, bank cannot engage external auditor. FBA brought Decision on minimum scope, content and form of program and report on economic-financial bank audit.	Compliant with BCPs (internal control and audit).
22	Accounting and Disclosure	Implementation of IAS is required and should become effective in 2007—2006 = CP21 (Accounting Standards)	Mandatory as stated in Law on accounting as of January 2007.	Largely compliant. Pursuant to FBiH Law on accounting standards translated to local language by authorized accounting body are being observed. IAS 6, 7 and amendments and explanations of standards published in 2005, 2006, 2007 by IFAC and IASB are not translated. FBiH banks observe IAS/IFRS especially banks owned by foreign owners. Both the Agency and external audits require banks to observe IAS which has been done. IAS 39 still causes problems because Banking law requires banks to observe international accounting standards and FBA regulations. What poses a problem is asset classification and percentage of specific reserves because FBA regulations are more conservative. Every year FBA requires external auditors to apply more conservative approaches in their reports that banks deliver to FBA: whether it is IAS 39 or FBA regulations, but to include note to show results if they applied another approach.
		Formally define qualifications of external auditor, and grant Agencies the power to revoke an auditor's license—2006 = CP21 (Accounting Standards)	See Supervisory Reporting above. FBA cannot revoke a license, but it can reject an audit. Every year, banks have to get FBA written approval to engage an external auditor and in such manner FBA	See Supervisory Reporting above.

			prevents access of under-qualified or compromised audit companies.	
23	Corrective and Remedial Powers of Supervisors	Increase maximum aMoUnt of fines—2006 = CP22 (Remedial Measures)	No change. Monetary fines not considered high enough.	Banking Law needs to change because this is the area that can be solely regulated by law. FBA position on this is that under existing banking law fines are too low, but there are many opponents to this opinion.
24	Consolidated Supervision	Implement a supervisory framework for evaluating risks arising from non-financial activities of a banking group—2006 = CP20 (Consolidated Supervision)	See Supervisory Techniques above.	See Supervisory Techniques above.
25	Home-Host Relationships	Establish formal relations with foreign supervisors, including through MoUs—2006 CP25 (Supervision Over Foreign Banks' Establishments)	MoU signed with supervisors from Slovenia, Croatia, Serbia, Montenegro, Albania, Greece, FYR Macedonia, Romania, Bulgaria and Cyprus. FBA is in final stage of harmonizing MoU text with Bank of Italy. On-site is the main subject. MoU text with Turkey has been harmonized, in part referring to on-site controls, while other parts are mainly harmonized.	Cooperation is mainly working. Even with FMA of Austria that does not want to sign MoU.
Source: Author's summary of FBA responses to questionnaire, May-June 2008				

APPENDIX 2

Status of Recommended BCP Actions in RS from 2006 as of 2008

CP #	Principle	Recommended Actions	Actions Taken	Current Status
1	Objectives, Independence, Powers, Transparency and Cooperation	Guarantee adequate financial resources for RSBA, and review salary scales and staffing needs—2006 assessment = CP1.2 (Independence); Ensure acting appointments to RSBA are confirmed without excessive delay—2006 assessment = CP1.2 (Independence)	The RSBA Law and Decision on unified tariff for payment of RSBA service fees for the supervision of banks, MCOs, savings groups and leasing companies (RS Official Gazette 63/06, RS Official Gazette 3/07, RS Official Gazette 35/07, RS Official Gazette 6/08). The formulas combined with growth of banks' assets and expansion of RSBA authority for supervision of other financial institutions has significantly contributed to the increase of the Agency's budget.	Financial resources are now adequate. Appointments are not necessarily confirmed more quickly, although the issue of excessive delays has not been a problem the last two years.
		Amend secondary legal framework and ongoing supervisory practice—2006 assessment = CP1.3 (Legal Framework); Amend law in order to ensure legal protection to supervisors—2006 assessment = CP1.5 (Legal Protection)	Immunity for supervisors and other RSBA employees was revoked in 2006, and for the Agency from civil and criminal suits.	RSBA has less protection in 2008 than in 2006. Secondary legal framework and ongoing supervisory practices are partly in process.
		Conclude MOU with the Security Agency—2006 assessment = CP1.6 (Information Sharing)		Plans to sign MoUs with Securities Commission and Insurance Agency in mid-2008.
6	Capital Adequacy	Account for market risk, country risk, and transfer risk in capital analysis and requirements—2006 = CP6 (Capital Adequacy)	The Agency has brought Decision on minimum standards for market risks management and Decision on minimum standards for operational risk management, that defines requests for additional equity based on: interest rate risk, foreign currency risk, price risk, delivery risk, other party risk, generating loss risk due to inadequate internal	These decisions become effective on December 31, 2008. These risks are still deemed low in the RS and BiH. Agency has started education of supervisors for market risks.

			systems, procedures and controls, illegal activities and harmful outside events.	
		Consult Rating Agencies regarding ratings for Government and CBBH obligations—2006 = CP6 (Capital Adequacy)	Rating agency is not included into rating obligations toward Government and CBBH	No action taken.
		Establish capital requirements for other risks—2006 = CP13 (Other Risks)	The Agency has brought Decision on minimum standards for market risks management and Decision on minimum standards for operational risk management, that defines requests for additional equity based on: interest rate risk, foreign currency risk, price risk, delivery risk, other party risk, generating loss risk due to inadequate internal systems, procedures and controls, illegal activities and harmful outside events.	These decisions become effective on December 31, 2008. These risks are still deemed low in the RS and BiH. RSBA has started education of supervisors for market risks. In addition to equity, legal reserves amount to 10% of stock holder equity.
7	Risk Management Process	Issue specific standards for risk management that cover and better enforce interest rate, operational and systems risks—2006 = CP13 (Other Risks)	See above re Capital Adequacy.	See above re Capital Adequacy.
		Establish capital requirements for other risks—2006 = CP13 (Other Risks)	See above re Capital Adequacy.	See above re Capital Adequacy.
		Training should be increased and the guidelines for examination procedures for other risks should be incorporated into the On-Site Supervision Manual—2006 = CP13 (Other Risks)	See above re Capital Adequacy.	See above re Capital Adequacy.
		Supervisors require targeted training in the area of market risks—2006 = CP16 (On-site and off-site supervision)	See above re Capital Adequacy.	See above re Capital Adequacy.
8	Credit Risk	IT specialists to assess the reliability and accuracy of the information supplied by the banks related to lending—2006 = CP7	The Agency's IT experts together with on-site controllers check data and harmonization of analytical records. Verification of accuracy	RSBA still needs greater capacity to validate systems and accuracy of data.

		(Credit Policies)	of financial reports is done by external auditors.	
9	Problem Assets, Provisions and Reserves	Revise definitions of loan categories and revise percentage of loan loss reserves—2006 = CP8 (Loan Loss Provisioning)	The Agency still has not done an evaluation for the classification of loans and reserve rates but more detailed analysis are being performed – simulation of impact of changes of the definition of some categories of loans and reserve rates on banks in terms of impact on increased requirements for reserves for loan losses, impact on profitability, equity, etc.	RSBA plans to adopt changes and amendments to the Agency's Decision on minimum standards for credit risk management and assets classification by the end of 2008 together with FBA.
		Establish reserves for foreign currency-indexed loans—2006 = CP8 (Loan Loss Provisioning)	Banks incorporate currency clause into their agreements and they do not analyze foreign currency reserves of their clients.	Instructions are not written.
10	Large Exposure Limits	Analyze large exposures on a consolidated basis—2006 = CP9 (Large Exposure Limits)	When assessing credit risk of the group of debtors, the Agency takes into account total exposure of the group of entities or beneficiaries, based on information provided by the bank.	Efforts are made to analyze credit exposure on a consolidated basis, but consolidated accounting is not observed and risks persist
		Improve the quality of information required to evaluate collateral—2006 = CP9 (Large Exposure Limits)	CBBH has established register of loans for legal entities and individuals where all banks are obligated to participate, and that is reliable to a good extent. The movables registry is also effective. RSBA requires that banks adopt policies and procedures to assess the adequacy of collateral. Appraisal of real estate and movables has been improved (the Agency accepts court appraisers' appraisals). Banks verify appraisers' appraisals with their internal procedures. Banks started issuing bonds, as well as municipals.	Quality of information that is available to banks for assessment of collateral has been improved, but there are still institutional problems (e.g., weaknesses of the land registry[22]). Thus, there is progress, but more is needed.
11	Exposure to Related Parties	Analyze connected lending on a	Control of bank exposure on individual	Compliant with BCPs.

[22] For more on this, see "Allow banks on-line access to land register", BH.BANKAR, 2008.

		consolidated basis—2006 = CP10 (Connected Lending)	basis and toward group of connected beneficiaries is performed during on-site examinations, and all bases for connected lending are taken into account.	
12	Country and Transfer Risks	Issue a decision specifically addressing country risk—2006 = CP11 (Country Risk)	RSBA has not issued a special decision, but existing regulations treat such receivables and include them as part of total credit risk.	No action taken specific to country risk.
13	Market Risks	Introduce capital charges for foreign exchange and other market risks—2006 = CP12 (Market Risk)	See above re Capital Adequacy.	See above re Capital Adequacy.
		Supervisors require targeted training in the area of market risks—2006 = CP16 (On-site and off-site supervision)	See above re Capital Adequacy.	See above re Capital Adequacy.
15	Operational Risk	Issue specific standards for risk management that cover and better enforce interest rate, operational and systems risks—2006 = CP13 (Other Risks)	See above re Capital Adequacy.	See above re Capital Adequacy.
16	Interest Rate Risk in the Banking Book	Issue specific standards for risk management that cover and better enforce interest rate, operational and systems risks—2006 = CP13 (Other Risks)	See above re Capital Adequacy.	See above re Capital Adequacy.
17	Internal Control and Audit	Issue specific standards for risk management that cover and better enforce interest rate, operational and systems risks—2006 = CP13 (Other Risks)	See above re Capital Adequacy.	See above re Capital Adequacy.
20	Supervisory Techniques	Training should be increased and the guidelines for examination procedures for other risks should be incorporated into the On-Site and Off-Site Supervision Manuals—2006 = CP13 (Other Risks)	On-going training of supervisors in this period.	Guidelines, i.e. procedures for supervision of other risks are not incorporated into the on-site and off-site Manuals.
		Supervisors should enhance their expertise in verifying the accuracy of financial statements and	The Agency's IT experts together with on-site controllers check data and analytical records. Verification of accuracy	Supervisors have some of the necessary expertise in verifying financial statements. More will be needed re market and operational risks.

		management information—2006 = CP16 (On-Site and Off-Site Supervision)	of financial reports is done by external auditors.	
		Supervisors require targeted training in the area of market risks—2006 = CP16 (On-Site and Off-Site Supervision)	See Capital Adequacy.	Additional training is planned.
		Supervisors should collect, review and analyze reports from banks on a solo and consolidated basis—2006 = CP18 (Off-site Supervision based on Bank Reports)	Banks' reports are collected, reviewed and analyzed on a solo basis. Consolidated supervision of banking groups is not performed. Participation of banks in subsidiary entities does not represent significant exposure against basic equity or against banking sector in total.	Not compliant. Work is needed in this area, particularly as banking legislation follows a universal model.
21	Supervisory Reporting	Supervisors should collect, review and analyze reports from banks on a solo and consolidated basis—2006 = CP18 (Off-site Supervision based on Bank Reports)	See Supervisory Techniques above.	See Supervisory Techniques above.
		IT specialists who can assess the reliability and accuracy of the information supplied by the banks in the loan area required—2006 = CP19 (Validation of Supervisory Information)	See Supervisory Techniques above.	See Supervisory Techniques above.
		Formally define qualifications of external auditor, and grant FBA the power to revoke an auditor's license—2006 = CP21 (Accounting Standards)	Decision on minimum standards of internal and external audit defines responsibilities and qualifications of external auditors while RSBA brought Decision on minimum scope, form and content of program and report on economic-financial audit of banks. Supervisory board and subsidiary entities of the bank cannot appoint external auditor without prior approval from RSBA (mandated by Law). The Agency has the authority to not approve the audit, although it does not have	Compliant with BCPs (internal control and audit).

			the power to revoke the auditor’s license.	
22	Accounting and Disclosure	Implementation of IAS is required and should become effective in 2007—2006 = CP21 (Accounting Standards)	Mandatory as stated in Law on Accounting as of January 2006. Accounting standards translated to Serbian language by authorized accounting body are being observed in the RS. Both the Agency and external audits require that banks observe IAS, which has been done apart from part where application of standards require adoption of the Agency’s secondary legislation. For example, credit portfolio is still based on uncollected portion, and not on depreciated value by applying method of effective interest rate. Collateral is not incorporated into calculation of cash flow (IAS 39).	Largely compliant. IAS 6, 7 and amendments and explanations of standards published in 2005, 2006, 2007 by IFAC and IASB are not translated. All banks in RS are owned by foreign banks or foreign individuals except for one small bank, and since 2006 there has been improvement in observing IAS/IFRS.
		Formally define qualifications of external auditor, and grant Agencies the power to revoke an auditor’s license—2006 = CP21 (Accounting Standards)	See Supervisory Reporting above.	See Supervisory Reporting above.
23	Corrective and Remedial Powers of Supervisors	Increase maximum aMoUnt of fines—2006 = CP22 (Remedial Measures)	In addition to monetary fines that are not insignificant, the Agency has set of measures as determined under article 125 of the RS Law on Banks that could be imposed on banks, supervisory board members, management board members, employees, individuals with proprietary interest in the bank or connected entities (written warning, letter for imposing special requirements for careful business conduct, fines, written warrant on temporary suspension of members of the Assembly, supervisory and management board,	RSBA disagrees with this recommendation. It believes sanctions are sufficient and impact on reputation is of greater importance in the RS market when sanctions are applied.

			employees, to appoint acting director, etc. to revoke banking license). In addition, when it comes to monetary fines with timeframe, additional monetary fine can be imposed in relation to amount of damage or unfulfilled obligation as high as 20 times amount of damage or unfulfilled obligation that is subject of offense. There is a risk of reputation that banks are exposed to when such fines are imposed, which causes more damage than the fine itself.	
24	Consolidated Supervision	Implement a supervisory framework for evaluating risks arising from non-financial activities of a banking group—2006 = CP20 (Consolidated Supervision)	See Supervisory Techniques above.	See Supervisory Techniques above.
25	Home-Host Relationships	Establish formal relations with foreign supervisors, including through MoUs—2006 CP25 (Supervision Over Foreign Banks' Establishments)	Signed Memorandum on supervisors' cooperation: Albania, Greece, Macedonia, Romania, Bulgaria, Serbia, Montenegro, and Cyprus. Formal procedures on exchange of supervision reports have been established with Slovenia-based supervisor (NSB) in the past two years.	Austria accounts for majority ownership in RS banks, but RSBA does not have signed Memorandum on supervision with FMA of Austria.

Source: Author's summary of RSBA responses to questionnaire, May-June 2008

APPENDIX 3

Chapter VI: Financial Sector Integration: Central Europe and the European Union
From Borish, Ding & Noel, "On the Road to EU Accession:
Financial Sector Development in Central Europe", World Bank, 1996

Introduction

Financial integration into the European Union means an integrated market for banking, insurance and securities. Any firm will be able to place securities on any stock exchange in the EU, while any individual and firm will be able to acquire those securities. In addition, any bank or insurance company will be able to offer its products directly into any EU market without having to formally set up a business there. To achieve this goal, three conditions are essential: (i) full freedom to establish operations and trade in financial services; this requires the harmonization of essential standards for prudential supervision of financial institutions, and for the protection of investors, depositors and consumers; (ii) mutual recognition of the competence of the supervisory bodies and standards of each member state; and (iii) based on the first two, home country control and supervision of financial institutions which wish to operate in another member state (European Commission, 1994). The Central European countries have made progress in this direction, although more needs to be done to develop supervisory institutions, personnel, and overall capacity.

As elsewhere in the world, the banking market in Europe is subject to intensifying competition and globalization. Competition between commercial banks and financial institutions has increased, and this will continue as the market for financial services expands. In addition to worldwide legal and regulatory changes, progress is also accelerating due to the revolution in telecommunications and information systems which is prompting an enormous expansion in capacity and linkages around the globe. This more competitive environment has encouraged banks and other financial institutions of all kinds to broaden and improve the quality of their services and strengthen their customer bases. On this count, the Central European banks generally lag their EU counterparts.

In EU countries, increased competition over time will result in price declines of financial products, the introduction of new banking products, increased merger activity, and radical changes in organizational structure. All of these developments have implications for the kind of banking, insurance and capital markets structures that prevail, and the kind of management and governance required for safe, sound and internationally competitive banking and financial services. The recent acquisition by large German commercial banks of London-based British merchant banks and securities houses is indicative of the kind of movement that can be expected to intensify in the coming years. This, in turn, has significant implications for the kind of banking and financial systems and capital markets that prevail (Anglo-Saxon vs. universal), including accounting standards and disclosure requirements which exceed traditional levels of transparency in most banking systems on the European continent. In Central Europe, even some of the basic hurdles involving privatization, corporate governance, regulatory frameworks, information systems, credit risk evaluation criteria, and private securities markets have yet to be mastered. Thus, while the Central European countries have made significant progress in recent years, their ability to accede to the EU is made all the more challenging by the ongoing elevation of competitiveness standards in EU and international markets.

Deregulation in the EU financial sector refers to the liberalization of financial markets to open up and compete more freely. Establishing the guidelines for a single license across the EU is an example of such deregulation. At the same time, supervision and prudential regulations in the banking and insurance sectors are by necessity becoming more formalized. Multinational directives on Solvency Ratios, Own Funds and Capital Adequacy are examples of standardized regulatory requirements that will be needed for effective supervision and financial sector stability. Central European banking systems have clearly moved in this direction, adapting regulations and accounting treatments to international standards. The insurance sector in these countries has also shown movement in this direction, although oligopolistic tendencies still prevail in some countries. The challenge at this point is more institutional than legal, with enhanced financial sector supervision and market capacity needed to identify threats to solvency and liquidity early enough to contain systemic risk.

Joining the EU integrated financial market means more competition and changing domestic rules for Central European countries. EU financial institutions that have been granted a license at home to conduct business will automatically be allowed to set up branches and to provide services directly to/in any member state of the EU without prior applications being made to or approved by the host country. Because these financial institutions will be subject to home-country control wherever they do their business, supervisors will have to know that minimum agreed standards are being applied by their fellow supervisors in other member states. For this reason, it is of paramount importance for Central European countries to understand the implications of financial sector liberalization and integration to be able to prepare for and adapt to the changing environment. Financial sector liberalization and integration not only imply adopting EU minimum rules and regulations, but more importantly, intensifying competition and structural changes in the financial sector. Most of the focus to date has been on the banking sector, although similar trends can be seen in the insurance sector and in development of capital markets. Increased competition may force inefficient or badly managed banks into technical insolvency due to their inability to render the same level of product or service quality as found with the competition. This has already happened with several small banks, although large banks in all Central European countries have been protected. While this practice has been observed around the world, public sector resources to recapitalize banks are finite, as recently found in Hungary. Nonperforming loans continue to burden large state banks' portfolios even after major recapitalizations. These high levels of nonperforming loans make it difficult for large SOCBs to recapitalize from earnings. Small Czech banks have been merged and liquidated, reflecting weaknesses on their part, and large Czech banks are now under pressure from foreign competitors. In Hungary, prime-rated banks are the most profitable, and fiscal pressures and the failure of four recapitalizations of state banks suggest that Hungary's private banks are likely to play a greater role in the years to come. In the end, competition will provide the growing private sector with a broader range of financial services and more efficient intermediation. Nevertheless, all countries will also need to recognize that level playing fields (standardized rules) will be prerequisites for successful competition, and this will include the closure of uncompetitive institutions to allow the better managed, more solvent and more liquid institutions to compete.

One major reform which must occur in the coming years for Central European countries to successfully integrate into the EU market is the free movement of capital. This is indispensable, as banking, insurance and investment cannot be freely provided across borders if access to foreign exchange is restricted.[23] The Capital Liberalization Directive (Council Directive 88/361/EEC of June 24, 1988)[24] is an important step removing all exchange controls in the EU. The Directive calls for removing controls on all capital flows within the EU, and for the most part, on capital flows between an EU member and any third country. For most EU members, this Directive was implemented from July 1, 1990. Exemptions were granted for Spain and Ireland until the end of 1992, and Portugal and Greece until 1995. In Central Europe, relatively free capital movements are found in Slovenia, and there has been gradual liberalization in the Czech and Slovak Republics, Hungary and Poland.

The Central European countries have liberalized exchange controls on their current account transactions,[25] but they still maintain some exchange controls for capital account transactions.[26] Along with continued progress towards open and competitive financial markets and strengthened enforcement of regulatory frameworks, the first step which Central European countries should take towards financial integration with the EU is to remove all exchange controls on capital movements. This free movement of capital should be applied not only to the capital flows between the Central European countries and EU members, but also among the Central European countries themselves as well as towards third countries. The Europe Agreements are only guaranteed free of restrictions on current account transactions. As far as the capital movement between the EU and each of the Central European countries is concerned, the Central European countries are allowed to keep their existing restrictions for a five-year transitional period, but not to introduce new restrictions. During the second stage of the transitional period, the Central European countries will be required to adopt EU rules on the free movement of capital.[27]

A Review of EU Directives

EU Directives in the Banking Sector

With respect to where the Central European countries stand in the context of financial sector integration with the EU, the banking supervision framework and minimum EU requirements

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[23] Before the 1980s, there were no systematic attempts to reduce trade barriers in the financial sector in the EU, although services had been addressed in the Rome Treaty. Moreover, trade in services had not been covered in multinational negotiations under the GATT until the Uruguay Round.

[24] The rules on capital movements laid down by this directive were replaced from January 1, 1994 by new rules contained in the Maastricht Treaty.

[25] Current account convertibility according to IMF criteria (Article 8) have been complied with in all countries except the Slovak Republic, as follows: (i) Poland since June 1995; (ii) Slovenia since September 1995; (iii) Czech and Slovak Republics since October 1995; and (iv) Hungary since March 1996.

[26] Slovenia is the most liberalized with regard to current account movements. Hungary has complied with OECD criteria since July 1996 by allowing residents to invest in any type of foreign securities and stock exchanges they choose (capital outflows), and by increasing the liberalization the capital inflows by permitting foreigners to invest in government securities. The Czech Republic has liberalized capital inflows, and outflows from trade-related credit and real estate transactions. However, restrictions are still in place on capital outflows for residents who wish to purchase foreign shares and deposit money in foreign bank accounts. In Poland, most capital account items had been liberalized in preparation for OECD membership in July 1996. This includes land purchases by foreigners, as well foreign investments made by Poles in other countries/markets. Poland expects to comply fully with OECD guidelines. In the Slovak Republic, gradual liberalization of the capital account has occurred. FDI and loans from abroad are permitted, and Slovak entities can lend abroad and purchase real estate in foreign countries. However, foreign entities are not permitted to purchase real estate in the Slovak Republic, nor are Slovak nationals permitted to open investment accounts abroad.

[27] The Europe Agreements between the EU and Poland and between the EU and Hungary were ratified by each member state and entered into force in 1994. EU Agreements with the Czech and Slovak Republics and Slovenia were ratified in 1995.

for the internal market must be taken into account. EU banks are subject to a wide range of directives covering most aspects of their existing business. The first banking directive-- First Council Directive 77/780/EEC of December 12, 1977-- lays down common standards for the granting of banking licenses and introduces the basic principle of cooperation between the supervisory authorities of different member states. This was followed in June 1983 by Council Directive 83/350/EEC-- the Consolidation Supervision Directive-- which required that credit institutions be supervised on a consolidated basis. Any credit institution owning 25 percent or more of the capital of another financial institution was to be supervised by the authorities in the owning institution's home state. Council Directive 86/635/EEC of December 8, 1986-- The Bank Account Directive-- harmonized the format and content of the annual accounts of all financial institutions within the Union.[28] To improve the efficiency of supervisory authorities across the EU, the Council also issued a directive on disclosure requirements of foreign branches (Council Directive 89/117/EEC of February 13, 1989). All these directives were intended to accelerate the process of harmonizing regulations within the EU.

Integration of the financial sector calls for free movement of capital, and free establishment across the EU. The Second Council Directive, 89/646/EEC of December 15, 1989, aimed to achieve (i) the essential harmonization needed to secure the mutual recognition of supervisory authorities and of prudential regulatory systems; (ii) a single license recognized throughout the EU; and (iii) application of the principle of home-country control. This second banking directive, effective from January 1, 1993, is one of the two foundations of the single market in banking; the Capital Liberalization Directive is the other one. The main contents of the Second Council Directive, or second banking directive, are summarized as follows:

- <u>Minimum Capital Requirements for Establishment</u>: New banks are required to have a minimum capital base of ECU 5 million (about US$ 6 million); other credit institutions, such as cooperatives and building societies, require minimum capital of ECU 1 million.

- <u>Single Banking License</u>: Any credit institution authorized in one member country can establish branches and provide services anywhere in the EU without requiring authorization from the host member state or the need for separate endowment capital.

- <u>Home-country Control</u>: A credit institution is authorized by its home-country to provide banking services in any member state through branches or by providing services without a branch.[29]

The related concept to home-country control is "mutual recognition", which means that the supervisory authorities in one country will recognize the prudential equivalence of other bank supervisors. The home country has responsibility for overall solvency, while the host country supervises the liquidity of branches on its territory. Authorization is a matter for the home country. The application and enforcement of prudential regulations, such as those relating to

[28] Banks were required to apply this directive at the latest on January 1, 1993. However, Germany, the Netherlands, Portugal and the UK introduced derogating rules.
[29] Home-country control also applies to other non-banking financial institutions which satisfy the following conditions: (i) they must be at least 90 percent owned by one or more credit institutions authorized in the same member state, and must be subject to consolidated supervision; and (ii) the commitments must be jointly guaranteed by the owners.

capital adequacy, are designed to ensure the solvency of the whole bank (including the branches in other member states) against the risk of counterpart default subject to home-country control. Mutual recognition has also been extended to the business conducted by financial companies that are part of the larger banking group. This provides opportunity for universal banking, yet properly supervises such universal banks by including non-core banking activities which could affect bank solvency and liquidity (Article 18 of the Banking Directive).[30] Key principles of mutual recognition include:

- Harmonization of the Conditions for Pursuing Banking Activities:[31] This requires maintenance of initial capital, control of the qualifying holdings, the existence of sound administrative and accounting procedures, and adequate internal control mechanisms.

- Investments: Maximum shareholdings in a single non-financial firm are permitted up to 15 percent, and investments can be up to 60 percent of a bank's own funds. Beyond these limits, shareholdings are allowed by member states, but must be covered 100 percent with a bank's own funds, and the latter should not be included in the calculation of the solvency ratio. Existing credit institutions with holdings exceeding the limits on January 1, 1993 (implementation date) had 10 years from that date in which to reduce those holdings.

- Reciprocity Clause, and Relations with Third Countries: The commission is authorized to have some influence on institutions from third countries. Third countries should grant EU credit institutions effective market access comparable to that granted by the EU to those from third countries. Another important element in this directive is the national treatment to EU credit institutions by the third country.

The second banking directive is supported by the Own Funds Directive and Solvency Ratios Directive. Own funds can serve to absorb losses which are not matched by a sufficient volume of profits. They also serve as an important yardstick for the assessment of the solvency of credit institutions and for other prudential purposes. The Own Funds Directive, issued in 1989 and amended in 1991 and 1992, set up common standards pertaining to own funds, and the criteria for determining the composition of own funds. However, each member state remains free to apply stricter rules than the common ones.[32] The Solvency

[30] However, this recognition is subordinated to certain conditions, such as (i) the controlling bank or banks must hold 90 percent of the voting rights by means of stocks and shares held in the finance agency; (ii) the controlling bank or banks must satisfy the authorities that the management of the finance agency is prudent, and declare themselves guarantors in co-surety of the obligations undertaken by the said finance agency; and (iii) the finance agency is included in the consolidated supervision to which the controlling bank is subject, specifically for the calculation of solvency ratios and for the control of large loans.

[31] The banking activities defined in the second banking directive include (i) the acceptance of deposits and other repayable funds for lending; (ii) financial leasing; (iii) money-transmission services; (iv) issuing and administering means of payments (e.g., credit cards); (v) guarantees and commitments; (vi) trading for one's own account or for a customer's account; (vii) participation in securities issues; (viii) provision of advice on capital structure, industrial strategy, mergers and acquisitions; (ix) money brokering; (x) portfolio management; (xi) safekeeping and the administration of securities; (xii) credit reference services; and (xiii) safe-custody services. In support of universal notions of banking, the second banking directive permits banks to engage in investment activities. These investment activities include portfolio management, underwriting services, brokerage and professional investment advice. However, equity acquisition in the non-financial sector is restricted.

[32] Council Directive of 89/29/EEC of April 17, 1989 on the "own funds" of credit institutions. Own funds consist of original own funds and additional own funds. The original own funds, also called core capital, consist

Ratios Directive (Council Directive 89/647/EEC of December 18, 1989) aims to harmonize prudential regulations and strengthen solvency standards to help maintain banking stability. The solvency ratio accounts for the proportion of own funds in total assets (risk-adjusted value) and off-balance sheet business. Credit institutions are required to maintain a minimum risk-adjusted ratio of 8 percent at all times. Member states are allowed to set higher ratios. If a credit institution's ratio falls below 8 percent (or below the higher national requirement), the appropriate supervisory authorities must ensure that the situation is restored.

As credit institutions in a unified banking market compete directly with each other, some legislation needs to be designed to ensure the quality of competition between credit institutions within the EU market. Monitoring and controlling large exposures of a credit institution is an integral part of prudential supervision. Excessive concentration of exposure to a single client or a group of connected clients may result in unacceptable risks and may cause bank insolvencies. Council Directive 92/121/EEC of December 21, 1992 (entered into force on January 1, 1994) is the directive for monitoring large exposures. This directive lays down the criteria throughout the EU for determining the concentration of exposures. These limits are as follows:

- <u>Large Exposure</u>: A large exposure to a client or group of connected clients is defined as one whose value is equal to or exceeds 10 percent of the lending institution's own funds.

- <u>Connected Lending Exposure</u>: A credit institution may not incur an exposure to a client or a group of connected clients where its value exceeds 25 percent of own funds. This limit is 20 percent in the case of exposures incurred to the parent undertaking of the lending institution and subsidiaries of that parent undertaking.

- <u>Aggregate Large Exposure</u>: A credit institution may not incur large exposures which, in the aggregate, exceed 800 percent of own funds.[33]

This directive ensures that the limit of large exposures (risk concentration) undertaken by credit institutions is legally binding at the EU level. Credit institutions are required to take necessary measures to bring down exposures in question to levels laid down by this directive by December 31, 2001 at the latest. The authorities must inform the Commission and the Banking Advisory Committee for the general process adopted.

With regard to deposit protection, all EU credit institutions are legally required to join in a deposit guarantee scheme. The deposit guarantee directive ensures a harmonized minimum level of deposit protection wherever deposits are located in the EU. This directive explicitly states that the level and scope of coverage offered by guarantee schemes should not become

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of the highest quality items: capital, disclosed reserves, and funds for general banking risks. Additional own funds, also called supplementary capital, consists of revaluation reserves, securities of indeterminate duration, hidden reserves, commitments of members of cooperative societies, and subordinated loans. Since the nature of the items constituting additional own funds is not the same as those constituting original own funds, the Directive very explicitly limits the former included in own funds. The aMoUnt of the additional own funds must not exceed the original own funds. In addition, certain items such as commitments of members of cooperative societies and subordinated loan capital which are included in additional own funds may not exceed 50 percent of original own funds.

[33] If member states impose more stringent measures than the limits mentioned above, they can derogate this Directive.

an instrument for competition. The maximum deposit guarantee for each depositor is ECU 20,000 (about US$ 25,000, or about one year's EU per capita income).

In industrial countries, cross relationships in both directions between banks and industries are not forbidden. However, maximum limits are ordinarily set, especially to avoid majority holdings which could lead to serious conflicts of interest and undermine the safety and soundness of the banking system. The Second Banking Directive allows banks to engage in securities transactions and investment activities, in addition to traditional core banking activities throughout the EU. The Capital Adequacy Directive (Council Directive 93/6/EEC of March 15, 1993) enables supervisors to lay down capital requirements for banks, as well as nonbank investment firms. These capital requirements are designed to ensure the solvency of the whole bank, including branches in other member states, against the risk of counterpart default. This directive aims to harmonize capital adequacy requirements for the securities business in the same way that the Solvency Ratio Directive together with the Own Funds Directive provides a common regulatory framework for banking. The Second Banking Directive allows for banks' involvement in non-financial businesses, albeit subject to constraints which refer to bank capital.

EU Directives in the Insurance Sector

There have been fewer directives in the insurance sector than in the banking sector, although they follow the same principles of free trade and investment, mutual recognition, and home country control. The main differentiation is between life and non-life insurance.

Life Insurance

Four directives have been issued for the life insurance sector. Key directives include Council Directive 79/267/EEC (March 5, 1979) and 92/96/EEC (November 10, 1992). The 1979 Directive provided the basis for EU life insurance, while subsequent directives have served as amendments to this directive. The 1979 Directive defined classes of life insurance and investment vehicles, authorized the separation of management and accounting of life and non-life activities, and provided guidelines for solvency margins and the establishment of a guarantee fund.

- Categories of Life Insurance and Authorized Investment Vehicles: The classes of life insurance requiring separate authorization are (i) life, annuities, and personal injury insurance; (ii) marriage and birth insurance; (iii) life and annuities connected with investment funds; (iv) permanent health insurance; (v) savings associations; (vi) capital redemption operations; and (vii) management of pension funds.

- Separation of Life from Non-Life Activities: No underwriting company may pursue non-life and life insurance activities simultaneously. Where financial, commercial, or administrative links exist between two undertakings (companies) engaged in life and non-life insurance, separate accounts must be maintained for each activity. Existing companies which pursue life and non-life insurance businesses may continue to do so provided that these are pursued by "separate management" (profits of activities separate from each other; minimum financial obligations are separately maintained).

- Solvency and Guarantee Funds: Articles 18 and 19 establish a minimum solvency margin which is imposed by the supervisory authority in each member state where the company's headquarters is located. The margin is defined as a function of mathematical reserves, capital, and the class of insurance activity pursued. Article 20 establishes the guarantee fund, which is equal to one third of the minimum solvency margin, and has to be at least ECU 800,000.

The 1979 Directive has been amended only three times. The most important amendment was added in 1992 (92/96/EEC) establishing the single license and home country rule, as well harmonizing regulatory issues such as large shareholding disclosure requirements (upon reaching thresholds of 20, 33, and 50 percent of the insurance company) and technical reserves.

Non-Life Insurance

While nine directives have been issued for the non-life insurance sector as compared with four in the life sector, the focus of the directives has been similar: solvency, supervision, and information disclosure on ownership. Key directives include Council Directive 73/239/EEC (July 24, 1973), 88/357/EEC (June 22, 1988), 92/49/EEC (June 18, 1992), and 95/26/EC (June 29, 1995).

- Solvency and Guarantee Funds: The First Council Directive in 1973 focused on solvency and the guarantee fund. Article 16 defines the solvency margin (the higher of two sums, which are based on premiums and on claims). Article 17 defines the guarantee fund as one third of the solvency margin, not to be less than ECU 400,000/300,000/200,000, depending on the class of insurance activity pursued.

- Supervision: The Second Council Directive of 1988 clarifies the powers and means of supervision and provides specific rules. This was strengthened in 1995 by the European Parliament and Council Directive of June 29, 1995.

- Notification: The Third Council Directive of 1992 (Article 15) establishes the requirement of notification to the authorities in the case of a legal or natural person acquiring/disposing of capital or voting rights in an insurance company such that their share rises above/falls below the levels of 20, 33, and 50 percent of the company. Article 17 defines adequate technical provisions to be established by insurance companies.

EU Directives in the Equities and Debt Securities Sector

The EU has come up with nine key directives (with additional amendments) since 1977, with most of the guidelines for capital market operations established by 1989. The first legislation (77/534/EEC Commission Recommendation of July 25, 1977) was a recommendation and therefore non-binding on EU members. Subsequently, the first directive (79/279/EEC Council Directive of March 5, 1979) established binding legislation for capital markets (e.g., conditions for issuing and listing debt and equity securities on exchanges). Subsequent directives have refined listing requirements, information disclosure requirements, supervision, the activities of investment funds, transferability of securities, notification requirements, and related issues central to capital markets operations and development. Of these, the most significant two--the Investment Services Directive and the Directive on Capital Adequacy of Investment Firms and Credit Institutions--were not passed until 1993.

The purpose of the first legislation (77/534/EEC Commission Recommendation of July 25, 1977) was to establish general and supplementary principles to harmonize individual securities markets in the EU. The Recommendation stressed the observation of certain basic principles, including: (i) fair, accurate, and timely information to be made available to the public; (ii) the equality of treatment with respect to investors and markets; and (iii) the duties of company managers and owners and financial intermediaries with regard to these principles. Reflecting these principles and the need for transparency, the Recommendation also sought to define or establish basic guidelines regarding (i) fraudulent means of affecting the prices of securities; (ii) secrecy with regard to information not yet made public; and (iii) information to be made public by companies whose shares are listed (reporting every six months), and their duty to make price-sensitive information public as soon as possible. The Recommendation also sought to protect minority shareholders by giving them the opportunity to dispose of their shares on identical conditions in the event of a takeover.

The Council followed up with a binding directive (79/279/EEC Council Directive of March 5, 1979) which specified several conditions for listing securities on exchanges. These mainly stressed the qualifications and obligations of companies to their shareholders/bondholders, and to ensuring that markets remain informed. Specified conditions were:

- Conditions for the Admission of Shares to Official Listing on a Stock Exchange: The minimum size of the company has to be ECU 1 million. The company also needs to have audited financial reports for a minimum of three years. In addition, a minimum 25 percent of subscribed capital has to be offered to the public.

- Conditions for the Admission of Debt Securities: The minimum aMoUnt of any listed debt security is ECU 200,000.

- Obligations of Companies Whose Equity Shares and Debt Securities are Admitted to Official Listing: These include (i) applying for the admission of any new public issues of shares of the same class; (ii) designating a financial institution as agent through which shareholders can exercise their financial rights; (iii) informing authorities before changing statutes; (iv) making publicly available annual accounts/reports, and any information on developments that might affect prices or changes in the rights of shareholders or company capital structure; and (v) providing equal information to each exchange in which its shares might be listed.

This directive was reinforced in 1980 (80/390/EEC Council Directive of March 17, 1980) and with subsequent amendments (90/211/EEC Council Directive of April 23, 1990 and 94/018/EEC of May 30, 1994). These directives and amendments focused on information disclosure and mutual recognition.

- Enhanced Information: 80/390/EEC established the requirements for the admission of securities to official listing on a stock exchange. Such listing was made conditional on the publication of an information sheet ("listing particulars"), which is to include the last three years' audited financial statements.

- Mutual Recognition: 90/211/EEC established the mutual recognition by other member states of a public offer prospectus approved in one member state in the preceding three months. 94/018/EEC facilitated the listing of a security in a member state if it was already listed in another by making it possible to exempt the issuer from the obligation to publish a listing particular.

These principles, along with the need for strengthened supervision, were the basis for 82/121/EEC Council Directive of February 15, 1982. This directive specified (i) the information to be published on a regular basis by a company whose shares were admitted to official listing (which include semi-annual financial reports); (ii) the powers of the supervisory authorities in carrying out their tasks; and (iii) the means of cooperation between member states (which include accepting wherever possible a single version of the report disseminated by the company).

As the capital markets developed throughout the EU and new investment companies (known as mutual funds, unit trusts, unit investment trusts, etc.) began to play an increasingly prominent role in the mobilization and management of investment resources, the EU adopted 85/611/EEC Council Directive of December 20, 1985 (later amended by 88/220/EEC Council Directive of March 22, 1988). This Directive established basic rules for the authorization, supervision, structure and activities of undertakings (investment companies) for collective investment in transferable securities ("UCITs") carried out by investment companies, excluding closed-end types. Accordingly, a unit trust or an investment company was required to entrust its assets to a depository for safekeeping. Restrictions on investment by a unit trust/investment company include the following:

- It can invest in transferable securities which are admitted to official listing, traded in another regulated market, listed or traded in a non-member state's exchange/regulated market if approved by the authorities, or a recently issued security if this is admitted to listing within one year of issue.

- It can invest no more than 10 percent of its assets in transferable securities (in shares, debt, or the sum of the two) other than those specified above.

- It can not invest in precious metals.

- It can not invest more than 5 percent of its assets in transferable securities issued by the same body. Exemptions are: (i) this limit can be raised to 10 percent provided the total of such investments exceeding 5 percent of its assets is not greater than 40 percent of its assets; (ii) the limit can be raised to 35 percent if the securities are issued/guaranteed by a member state/its local authorities/those of a non-member state/a public international body of which one or more members are member states; (iii) it can invest up to 100 percent of its assets in different issues by the same issuer mentioned in (ii) as long as it holds investments in at least six different issues, and has obtained authorization from the appropriate supervisory body to invest more than 35 percent in the mentioned issuer and had indicated this intention in its statutes and prospectus; (iv) as added by amendment 88/220/EEC Council Directive of March 22, 1988, the limit may also be raised to 25 percent in the case of bonds issued by a credit institution registered in a member state, provided that the total of such investments, each of which exceeds 5 percent, does not exceed 80 percent of assets.

- It can invest no more than 5 percent of assets in another UCIT. However, it may invest in another UCIT linked with itself only upon authorization (to be granted if a geographic/economic specialization exists).

- An investment company or management company acting in connection with all of its unit trusts which it manages may not acquire any shares with voting rights which would allow it to exercise significant influence over the management of an issuing body.

- A UCIT may acquire a maximum of 10 percent of nonvoting shares of any issuing body, 10 percent of the debt security issued by any single issuing body, and/or 10 percent of the units of any single UCIT. These limits can be waived if the issuer is a member state or non-member state government or local authority.

The 88/627/EEC Council Directive of April 17, 1989 established the requirement of notification within seven days to the authorities when a natural/legal person acquires/disposes of shares in a listed company such that their resulting ownership crosses the thresholds of 10 percent, 20 percent, 33 percent, 50 percent, and 67 percent of the company. A member state can substitute the single threshold of 25 percent for 20 percent and 33 percent and 75 percent for 67 percent. Also, the public must be informed of any legal/natural person who holds 10 percent or more of the voting rights of a company. Subsequent directives have dealt with prospectuses (89/298/EEC Council Directive of April 17, 1989), and insider dealing (89/592/EEC Council Directive of November 13, 1989).

The most significant legislation in the area came in 1993, as Council Directive 93/22/EEC of May 10, 1993 on Investment Services in the Securities Field was finally passed. In many ways parallel to the Second Banking Directive, the Investment Services Directive allowed investment firms such as brokers, portfolio managers, and professional investment advisors to offer their services throughout the EU, establishing the single license rule, mutual recognition, and home member state supervision for investment firms. Since the Second Banking Directive had already allowed banks to engage in securities activities throughout EU, the Investment Services Directive was in effect aimed at giving equal opportunities to non-bank investment firms as banks.

The directive also defined the basis of access to regulated markets in member states. Accordingly, an investment firm or credit institution from an EU state can become the member of a regulated market in another EU state in the following manner: (i) *directly*, by establishing a branch; or (ii) *indirectly*, by establishing a subsidiary or acquiring an existing firm which is a member of the regulated market in the host country. Therefore, the directive eliminated the need for a bank to set up a specialized subsidiary to carry out investment services, conforming to the universal banking model already in place in most European countries. Those countries which required banks to set up such subsidiaries when the directive was adopted could continue to do so in a non-discriminatory way until the end of 1996.[34] The directive also stipulated that the Commission would submit a report to the Council by the end of 1998 regarding the consequences for those countries for which the directive indicated a major structural reform, and left open the possibility of reviewing its decision on barriers placed on banks in the future.

In addition, the directive introduced disclosure requirements for the acquisition/disposal of shares in an investment company, bringing the ownership level above/below 20, 33, and 50 percent, and the requirement to fulfill the capital adequacy standards stipulated in a

[34] Spain was exempted until the end of 1999.

supplementary 1993 directive. The directive on capital adequacy for investment firms and credit institutions (93/6/EEC Council Directive of March 15, 1993) defined capital adequacy standards and established the possibility of using alternative definitions of capital for non-bank investment firms and banks in view of the different types of risks faced by each.

APPENDIX 4

EU Recommendations for the Strengthening of Banking Supervision in BiH

Recommendation		Actions to be Taken by CBBH	Timeline
1	Better information of the CBBH on banking supervision issues	• Change in the agenda of meetings between CBBH and the Agencies to include banking supervision issues, information on individual banks, and comments on Financial Stability Unit reports to improve connection between financial stability and banking supervision [see cell below] • Establish CBBH newsletter • Feedback on Working Groups set up by the Agencies	<1 year
		• Better information flow *between* CBBH and Agencies, with the latter providing additional and more timely banking sector information to CBBH and CBBH's Financial Stability Unit sharing its findings regularly with the Agencies • Involvement in the implementation of common rules in the two entities that are in accordance with international standards of banking regulation and supervision; specific areas of importance include valuation methods and how these impact risk and capital calculations, along with the quality of external auditors of banks • Enhance capacity to monitor for and manage credit and liquidity risks in the banking sector • CBBH should conduct stress tests with Agencies' participation and share results with the Agencies for discussion on potential remedial actions to be taken • CBBH should be transparent with the public regarding its role in both banking supervision coordination and financial stability	
2	Set up a Main Indicator table for the CBBH Management Committee	• Synthesis of relevant information on activities of the Agencies and the banking system	<1 year
3	Implement MoUs with main home foreign supervisors and develop cooperation with other BiH financial supervisors	• Implement MoUs with national supervisors of main banking groups operating in BiH • Strengthen cooperation with domestic supervisors, particularly with a focus on securities markets	1-3 years
4	Exchange information with banking industry and all parties involved in bank audits	• Organize conferences and workshops under CBBH auspices	1-3 years
5	Provide CBBH with information on banks' liquidity	• CBBH should receive information that permits it to monitor banks' liquidity risk and potential failure of borrowers that would impact banks' ability to deal with short-term liabilities	1-3 years
6	Provide CBBH with information on banks' potential problems	• CBBH should receive information from the Agencies following on-site examinations or inspections, with a focus on weak banks and associated risks of those banks to financial stability	1-3 years
7	Set up emergency procedures for crisis situations	• Establish procedures for crisis situations, including warning indicators and any significant facts that could jeopardize banks' solvency and/or liquidity	1-3 years

8	Implement consultative procedure of CBBH prior to enforcement sanctions by Agencies	• Establish procedure by which CBBH would serve as observer or be more directly involved in the decision-making process regarding sanctions for banks' non-compliance	1-3 years
9	Implement consultative procedure of CBBH prior to issuance of any draft regulation by Agencies	• Include CBBH as part of Working Groups on discussion of new regulations • Agencies should formally consult with CBBH before adoption of any regulatory changes	1-3 years
10	Implement common human resource policy	• Involve CBBH in Agencies' plans to hire, prepare job descriptions, develop career schemes, and establish codes of conduct • CBBH closely cooperates with Agencies but takes the lead in assessing needs and selecting experts on technical matters re Basel II, IFRS, risk management and IT audits	1-3 years
11	Set up common administrative functions	• Coordination between CBBH and Agencies to reduce costs and harmonize banking supervision equipment	1-3 years
12	Implement common supervisory disclosure policy	• Coordinate and observe common practices on disclosure of information from Agencies to public on their actions and decisions • CBBH increases its disclosure re its role in supervision	1-3 years
13	Identify differences in call reports and regulation and revise them for consistency with EU standards	• Conduct an in-depth review and profile gaps that exist between entity standards and those observed by the EU • Harmonize banks' data transmission processes • Comply with the European reporting framework adopted by the Committee of European Banking Supervisors	3-6 years
14	Implement common off-site monitoring methodology	• CBBH should ensure consistency of Agencies' off-site monitoring methodologies • CBBH should ensure methodologies are fully compliant with international standards and practices	3-6 years
15	Implement common methodology for Agencies' on-site examinations and remedial actions	• CBBH should ensure on-site audit approaches and sanctions-taking processes are similar, risk-sensitive, and consistent with EU legal standards • CBBH should be consulted on Agencies' annual audit plans before adoption by Agencies' Management Boards	3-6 years
Source: Author's summary of EU recommendations for banking supervision in "CARDS Programme for the Central Bank of Bosnia and Herzegovina—Needs Analysis", European Union, March 20, 2007			

APPENDIX 5

IOSCO-Related Status in the Federation as of mid-2008

Question	Framework	Current Status	Actions Needed
Is there adequate protection in the legal and regulatory environment for investors re IOSCO standards?	Preconditions	Though the legal regulations on Securities and the Penal Code provisions are not as detailed as IOSCO regulatory standards, i.e. directives of EU, they are expanded to the extent possible to cover major situations of price and market manipulation, i.e. preferential information usage, and as such they offer a sufficient basis for protection of investors' interests.	No response.
Are the capital markets fair, efficient and transparent?	Preconditions	The capital market in FBiH is fair, as the unique regulations apply to all participants. For many less liquid securities, this is not that effective, and for liquid securities, this is measured from weak to medium. A regulatory basis for transparency exists and is applied to the greatest extent.	No response.
What are the key systemic risks or potential systemic risks associated with banks' exposure to the capital markets in BiH?	Preconditions	The banks exposed to the capital market share systematic risks associated with country risk and we cannot tell that that there is a specific systematic risk associated with them (except for potential changes of regulations that would limit their operations)	No response.
Are the preconditions in place for effective securities regulation, namely the macro-prudential setting and corresponding infrastructure and regulatory environment?	Preconditions	The Parliamentary procedure for making laws and changes of law is very slow and pretty much ineffective, which makes conditions for capital market regulation significantly difficult.	No response.
What is the status of the securities regulator as a counterpart for risk-based supervision?	The Regulator	Regulator is independent, specialized institution of Federation BiH, with the status of a legal person.	No response.
How much capacity for self-regulation exists in BiH, and what is the potential impact on financial stability?	Self-Regulation	A capacity for self-regulation in the light of professional brokerage, i.e. self-regulation in the stock	No response.

		exchange, is regulated and is big enough. However, this capacity has not been used much so far (except for drafting and application of the Stock exchange book)	
How effective is the enforcement of securities regulation, and what is the potential impact on the banking sector?	Enforcement	Supervision of securities regulation regarding detection and investigation has been effective so far as well as the Commission's primary measures. However, court proceedings on offenses and criminal liabilities are too slow and ineffective, and give suboptimal results. The influence of supervision of the banking sector is effective as much as the banks are involved in market transactions.	No response.
Is there cooperation in regulation domestically and internationally, with particular focus on financial conglomerates and cross-border transactions?	Cooperation	Domestic and international cooperation is fine. The preparations for integration into Multilateral Agreement on Exchange of information with other member commissions to IOSCO are in progress, which will further extend current cooperation.	No response.
Profile BiH issuers in the securities market and their impact on banks' earnings, funding and capital.	Issuers	Issuers in BiH are the companies emerged from the privatization process and the scope of their profiles is very broad. The participation of these companies on the primary market (as an alternative to bank loans) has not been significant so far.	No response.
Profile BiH collective investment schemes and their impact on banks' earnings, funding and capital as well as operational and broader risk management issues.	Collective Investment Schemes	Closed investment funds in FBiH have been transformed into privatization funds that actually were transitional tools in the privatization process. Regardless of their size, their impact on banking sector (as an investor, capital creditor or as an alternate saving) is very little. A trend of forming open mutual funds has recently been recognized as a serious alternative to bank savings, but these funds by size (financial capacity) are not	No response.

		very important compared to the banking sector. Because of the specific stream and conditions of fund portfolios as well as specific conditions for portfolio management (all investments, per the law, are still focused on securities from BiH), risk management is quite difficult.	
Profile BiH securities market intermediaries and their impact on banks' earnings, funding and capital as well as operational and broader risk management issues.	Market Intermediaries	Professional intermediaries in the capital market (except for two established by banks) are small private companies that so far have been profiled as retail brokers. A trend for improving the operations of these companies has recently been recognized in terms of providing an extended offer of investment services (investment advising, portfolio management, etc) that should extend its power related to the banking sector (which is still too small)	No response.
Profile the BiH secondary market in securities and its impact on banks' earnings, liquidity, funding and capital as well as operational and broader risk management issues.	Secondary Market	Secondary market (stock exchange) in FBiH is e-stock exchange with auction-based trading for smaller securities and continuing system (muti fixing) for liquid securities. Effectiveness in closing of transactions is relatively good, as is securities settlement. There also exists a centralized account and settlement, and a new functional fund of reserves is established within the Securities Register. The negative effects on market effectiveness include a larger number of sellers than buyers, as well as a difference in their financial capacity (sellers have limited resources). The market is also badly affected by a trend of concentrating ownership in a significant number of liquid companies with the aim of taking control of them.	No response.
Note: Current Status explanations provided by Federation Securities Commission.			

APPENDIX 6

IOSCO-Related Status in the Republika Srpska as of mid-2008

Question	Framework	Current Status	Actions Needed
Is there adequate protection in the legal and regulatory environment for investors re IOSCO standards?	Preconditions	New standards adopted in 2006. Consistent with EU standards.	Company Law in process and expected in 2008 which will strengthen the legal framework.
Are the capital markets fair, efficient and transparent?	Preconditions	Information portal focuses on enhancing transparency. Working to achieve a more open culture. Some outreach re governance and shareholder education.	Consideration of free float requirements.
What are the key systemic risks or potential systemic risks associated with banks' exposure to the capital markets in BiH?	Preconditions	No systemic risks due to low exposures.	Preparation for when banks will rely on the capital markets more for funding, liquidity management, etc. and when their exposures will be more sensitive to movements on the Exchange.
Are the preconditions in place for effective securities regulation, namely the macro-prudential setting and corresponding infrastructure and regulatory environment?	Preconditions	Banks are private and foreign.	General development of the real sector needed. Refinements to tax policy needed.
What is the status of the securities regulator as a counterpart for risk-based supervision?	The Regulator	No real status because of currency board regime and limited government securities market.	Need staff to increase efficiency on issues like insider trading, connected party transactions, and technical assistance if a future government securities market emerges
How much capacity for self-regulation exists in BiH, and what is the potential impact on financial stability?	Self-Regulation	Limited market capacity re risk management, and little self-regulatory capacity.	Would need entire framework and action plan for development.
How effective is the enforcement of securities regulation, and what is the potential impact on the banking sector?	Enforcement	No real problems. Courts are generally reliable. RSSC is working with judges to expose them to commercial matters.	Nothing mentioned.
Is there cooperation in regulation domestically and internationally, with particular focus on financial conglomerates and cross-border transactions?	Cooperation	Cooperation is in effect with domestic agencies and securities commissions abroad.	Working on multilateral MoU with IOSCO to serve as umbrella agreement with other regulators around the globe.
Profile BiH issuers in the securities market and their impact on banks' earnings, funding and capital.	Issuers	See text. Banks relatively inactive as issuers, and there is little impact on banks' operations.	Market needs to develop.
Profile BiH collective investment schemes and their	Collective Investment	See text. Banks relatively inactive as issuers, and there	Market needs to develop.

impact on banks' earnings, funding and capital as well as operational and broader risk management issues.	Schemes	is little impact on banks' operations.	
Profile BiH securities market intermediaries and their impact on banks' earnings, funding and capital as well as operational and broader risk management issues.	Market Intermediaries	See text. Banks relatively inactive as issuers, and there is little impact on banks' operations.	Market needs to develop.
Profile the BiH secondary market in securities and its impact on banks' earnings, liquidity, funding and capital as well as operational and broader risk management issues.	Secondary Market	See text. Banks relatively inactive as issuers, and there is little impact on banks' operations.	Liquidity is key problem. Low level of secondary market trading activity. Market needs to develop.
Note: Author's summary of responses from meeting with RSSC.			

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** The author also reviewed laws, regulations, and decisions of the Supervision Agencies*