

**National Bank of Yugoslavia
Strengthening Bank Supervision
PCE-I-00-99-00006-01
Strengthening Bank Supervision Bridge Contract
169-C-00-03-00101-00**

**Contract End Report
For the period ending
30 April 2003**

Executive Summary

A bullet point review of the achievements

- Preliminary training for Bank Supervisory Strategies – Joel Hefty, Kat Woolford
- Training for supervisors and bankers on IAS – Matt Macellaro
- Specialist training in financial instruments for selected examiners – Susan Ballinger
- Basic bank supervision training – Shapiro, Woolford, Hefty, Callis
- Development of RTGS system and testing for all banks – Borislav Todorovic
- Travel of two bank supervisors to attend FED/World Bank Senior Supervisors seminar – Lori Bittner, Adrienne Sharkey
- Development of Anti-money laundering manual segment by US Treasury Advisor – Jerry Rowe, Jim Wright
- Development of payment system supervision manual segment – Kat Woolford
- Review of draft accounting law (Accounting Law passed in January 2003) – Kat Woolford, Matt Macellaro
- Completion of ratio analysis spreadsheet for use for Bank Strategy preparation – Kat Woolford

As noted resident and short term advisors assisted in all aspects of the above activities.

Dramatic progress was made on the payment system transformation. See quarterly activity memo from Borislav Todorovic on the payment system transformation.

Banking supervision appears to have turned a corner with the implementation of the Supervisory Development plan adopted by the Governor of the NBY. This plan shown in Appendix B details aggressive goals for the implementation of modern risk based supervision approach. Advisors Hefty and Woolford assisted in the development of the plan and with the modeling of the goals for its accomplishment.

During the later half of 2002, accounting reform moved at a somewhat slower pace due to changes to the political make up of Yugoslavia with the transition to Serbia and Montenegro. However, as shown above the Accounting Law did get passed in January 2003. See Matt Macellaro's December monthly report for a review of the training activities conducted in cooperation with the Commercial Bankers Association. In early 2003, accounting reform moved ahead considerably faster with the formation of the technical working group for the accounting commission and plans for the translation of IAS into Serbian and the development of accounting curriculum for universities in late 2003.

The major stumbling block to the complete fulfillment of the task order is the continued blockage from joining bank examinations coupled with the scarcity of full scope examinations during 2002. Overall, task order requirements are generally met and work continues. Contacts are made and relationships are developed at every level in the bank, with all departments.

It is the work outside the task order, which has made a great contribution to the strengthening of the financial sector in Serbia particularly in the areas of improved access to funds through the RTGS and increased transparency via the enactment of IAS related legislation. Banking supervision, as is seen in many other countries, has made deliberate progress with the introduction of its mission statement, the development of a portfolio manager approach, and the supervisory development plan.

In regards to banking supervision, the ongoing evaluation of its compliance with the Basel Core Principles of Effective Banking Supervision reveals that significant improvements have been made to the legal and economic infrastructure of banking supervision without substantive progress in execution of the principles.

TASK ORDER/WORK REQUIREMENTS

The period of performance for the two referenced Task Orders is from April 1 2001, to April 15, 2003.

1. Assessment

- a. The advisor(s) will begin an overall assessment of bank supervision in the FRY, including the legal/regulatory framework, institutional capacity of the NBY, on-site examination policies, procedures and staff capabilities, regulatory reports, off-site analysis, licensing policies and procedures. This assessment will help determine the status of bank supervision in the FRY in relation to the 25 Basle Core Principles of Bank Supervision. These findings will be used as a benchmark to determine future progress.
- b. The advisors will also undertake a training needs assessment as the basis for the formulation of a classroom based training supervision accreditation program.

2. On-site Examination Policies/Procedures/Training

- a. The advisors will develop and implement an on-site inspection process based on prudential bank regulations, which would result in a CAMELS (capital, assets, management, earnings and liquidity, sensitivity to market risk) type rating process. This will consist of developing inspection procedures for the on-site inspection of all major areas of bank activity, classroom training of these procedures, and training in and testing of the procedures during on-site inspections. A pivotal part of the program will be advisors participating in on-site inspections alongside NBY examiners.

The advisors will assist the NBY in drafting the policies and procedures relating to the overall inspection process. This will include procedures for planning the inspection, conducting the inspection on-site, formatting work papers and communicating inspection results.

- b. The advisors will assist the NBY in developing a basic on-site inspection manual based on OCC/FED models, but customized to FRY/Serbian law and practice. This will include helping in the development of an outline for the manual, drafting chapters, testing the policy and procedures in the chapters during on-site examinations, providing classroom training geared toward the chapters and helping to put the chapters in final form.
- c. The advisors will work with NBY staff in finalizing the format for the “report of inspection” which will be used to communicate inspection findings to both bank management and the management of NBY. This report will be tested during on-site inspections to determine its usefulness and to train inspectors in preparing the report.

- d. The advisors will work with NBY in developing administrative procedures for remedial action to address areas of concern disclosed by the onsite inspection.

3. Strengthening Off-site Supervision

- a. The advisors will assist the NBY in developing and implementing an effective and timely regulatory reporting process. An effective regulatory reporting process will provide a basis for the early detection of problems as well as the bank performance reporting process.
- b. As part of 3a the existing Chart of Accounts, reporting formats and processing of regulatory reports will be evaluated to determine their comprehensiveness and effectiveness in providing necessary data. With a view to streamlining the reports, recommendations for modifications, additions or deletions will be provided to the NBY.
- c. The advisors will assist the NBY in developing instruction manuals and/or training seminars to ensure that bankers as well as examiners understand the financial reporting requirements. The need for banker training in the preparation of regulatory reports/accounting rules will be determined.
- d. The advisors will assist the NBY in beginning the elaboration of an internal bank rating system to provide an analytical basis for making supervisory decisions. The rating system should appropriately identify risk(s) in a financial institution and correspond to certain types of enforcement actions similar to the CAMEL rating system used by many OECD countries. The rating system will also incorporate ratings for risk management. The advisors will develop written policy guidelines and procedures based on the above recommendations. Training will also be provided to inspectors in the use of the bank rating system.
- e. The advisors will work with the NBY in beginning the development of an early warning process setting forth criteria, which would serve as the basis for identifying troubled banks. This is a prerequisite for the NBY taking measures/requiring corrective actions to resolve problems before they become irremediable. The specific ratios will be developed as well as procedures for performing the periodic analysis using the ratios and other criteria. Inspectors will be trained in these processes.
- f. An assessment of the effectiveness and capabilities of the computer systems and back office operations will be conducted to ensure their appropriateness and ability to support the mission of NBY. The advisor will recommend enhancements and prepare technical specifications for any additional computer hardware and software required.

4. Legal/Regulatory Framework/Enforcement

- a. Based upon their review of current laws and regulations (particularly prudential regulations, enforcement authorities, and licensing) the advisors will make recommendations and help draft, where necessary, legislation and regulations to

provide a better framework for bank supervision. The advisors will work closely with the IMF in this area.

- b. The advisors will assist the NBY in developing a range of tools consistent with current banking law which can be used to enforce corrective actions by the banks and to resolve weaknesses identified during onsite and offsite analyses.
- c. Based upon the review of existing enforcement processes and supervisory authorities, the advisors will make recommendations for enhancements, modifications or additions.
- d. The advisors will assist in the introduction of new regulations and policies to the financial and accounting community by conducting meetings, seminars or training, as may be needed

5. Problem Banks

- a. At the completion of the USAID "Problem Bank Resolution" project estimated in October 2001, the advisors will take-over responsibility for problem bank work at the NBY. The advisors will assist the NBY to implement the policies and guidelines adopted by the NBY to work with management of troubled banks that are not transferred to the Bank Rehabilitation Agency (BRA).
- b. Advisors will assist the NBY in developing techniques to resolve issues through a variety of actions (e.g., merger; change of ownership; new capitalization; resolution of problem assets; as well as liquidation.) Training will be provided to appropriate personnel in the use of these actions.
- c. The advisors will work with the staff, management and expatriate advisors of the BRA as directed by the Vice-Governor at the NBY for Banking, and with the approval of USAID.

6. Bank Licensing

- a. The advisor will assist the NBY in developing and implementing new procedures and criteria to analyze applications for new bank licenses and banking activities. These procedures and criteria should provide the basis to determine the integrity of ownership, the adequacy of management and reasonableness of the business plan.
- b. The advisors will provide training to NBY staff in the use of these new procedures as required.

7. Organizational Development

- a. Assist in the formulation and implementation of an overall mission statement and strategic plan for bank supervision. The mission statement and strategic plan will outline the role, and overall goals and objectives of bank supervision.

b. Assist bank supervision management in the development of a performance based employee assessment program directly tied to salary and benefits.

8. Miscellaneous

a. As requested by the NBY and approved by USAID, the advisors will assist the NBY in other banking sector issues, including but not limited to, deposit insurance and payments related issues.

BENCHMARKS AND TANGIBLE RESULTS

The contractor understands and agrees that achievement of the Tangible Results and Benchmarks (appendix B) are the essence of the Task Order and that USAID will judge the contractor's success (or lack therefore) in the Task Order based upon whether or not the Tangible Results and Benchmarks are achieved. In the event that any one or more of the Tangible Results and Benchmarks are not achieved or should the contractor at any time realize that they are not achievable, then the contractor shall immediately advise USAID in writing and in the next quarterly report as part of the Task Order Reporting Requirements (i.e. monthly, quarterly or "completion" report) shall provide a complete explanation of the circumstances relating thereto.

TANGIBLE RESULTS

1. The NBY will have begun to examine licensed banks according to an annual schedule based upon perceived risk, which banks pose to the overall banking sector.

During the year 2002 and early 2003, the NBS made many bank contacts and supervisors performed numerous targeted examinations. These examinations were ordered by the Governor of the NBS based on his appreciation of risk within the system as advised by the Supervision Department. A formal approach to evaluating and classifying risk is in the process of formulation. The Supervisory Development Plan requires the preparation of bank strategies for individual banks and the appointment of portfolio managers. The first e.

2. The NBY will have developed a basic on-site examination manual based upon CAMELS components (capital adequacy, assets, management, earnings and liquidity, sensitivity to market risk) and a risk management assessment, which is used during on-site inspections.

The on-site examination manual was developed and presented to management of the supervision department. The advisors worked with teams from the supervision department to refine and adapt the examination manual to Serbian laws, regulations, and commercial bank culture. This year long process concluded in late November. Two additional manual segments were also presented in addition to those originally planned. They were Anti-Money Laundering and Payment Systems. These have also been translated into Serbian and are currently under review.

3. The NBY will have developed a training program and training materials for both on-site inspection and off-site analysis and a core group of examiners trained in all aspects of these disciplines.

A training and development plan was presented early in 2002. The supervision department management has not addressed this plan as it has been preoccupied during the year with the Supervisory Development Plan and related activities, and with the implementation of the accounting law and the new supervision regulations and reports. Training has been delivered on all aspects of the manual in both classroom and one-on-one training activities.

4. The NBY will have developed standardized documents relating to on-site examinations e.g., request letters to bank management, reports of examination and formatted working papers. Inspection staff will have received training in using these documents.

All documents referred to above have been developed and training has been delivered.

5. The NBY will have established an organizational structure, which supports effective and efficient bank supervision -- position descriptions, which reflect duties and responsibilities and reporting requirements.

NBY organizational structure has changed during 2002, but the optimal structure has not yet evolved. As is consistent with experience in other central and eastern European countries, the knowledge is power maxim continues to hamper effective support of the diverse activities of a central bank. While all department heads attend a collegium every week with the governor, there is evidence that they do not appear to listen to what is happening in these meetings. As a case in point, the head of the supervision department appeared to be completely unaware that the payment system reform would move ahead despite the fact that the new RTGS was discussed at every meeting during the fall of 2002. A further example of the lack of communication between departments is the fact that the NBY web site statistical report shows loan growth of 87% for the year 2002, while the supervision department appears to be neither aware nor reacting to this significant growth.

6. The NBY will have begun revision of the Chart of Accounts to comply with IAS and also begun streamlining regulatory reports required of the banks and made them consistent with the new Chart of Accounts.

The Accounting law was enacted during the month of January 2003. Several drafts of the IAS compliant chart of accounts have been developed in cooperation with the Accounting Department, but none as of the date of this report are sufficient to meet the accounting needs of the banks nor do they completely address all aspects of IAS requirements for IAS 30 and IAS 39, for example. It is anticipated that the chart of accounts will be completed and forwarded to banks before the first of March. However this is only anticipation, events often occur which put these modest deadlines out of our grasp.

One of the most significant problems encountered in all of the above task order requirements is that the NBY is not politically independent. 2002 was an election year and with 3 failed elections and a politically active governor. There is little hope of decisive action in the banking system during 2003 without the strict implementation of the Supervisory Development Plan. Without the adherence to the plan, the governor is the only individual who may decide on examination schedules and supervisory activities, this leaves the supervision of banks completely dependent upon the governor's political aspirations or personal grudges. Further, the NBY is an excellent example of a despotism. While the governor acts without the input of a formal board of directors, each department head has his/her own mini despotism which acts independently of each other department as demonstrated above. The organizational structure is not so flawed as the organizational culture.

BENCHMARKS

Within 45 days

- A work plan will have been approved by USAID with more detailed benchmarks for the first six months.

Met Partially Met Not Met

- The overall bank supervision assessment will have been completed and NBY management briefed on findings and weaknesses identified

Met Partially Met Not Met

- The training needs assessment will have been completed and a training schedule for the first six months determined and approved by NBY management.

Met Partially Met Not Met

Within 90 days

- First training courses will have been provided to NBY examination staff

Met Partially Met Not Met

- An NBY working group (including NBY staff and expert advisors) responsible for the drafting of the on-site supervision manual will have been established.

Met Partially Met Not Met

- The Chart of Accounts and regulatory reports will have been reviewed and recommendations made for revisions

Met Partially Met Not Met

- Advisors will have participated in at least one on-site inspection

Met Partially Met Not Met

Within 120 days

- The NBY working group will have an agreed Table of Contents and the first three chapters of the on-site inspection manual will have been drafted. Inspection staff will have received classroom and on-the-job training in these topics that will focus on general examination controls, documentation, and credit.

Met Partially Met Not Met

- The format for the Final Report of Inspection will have been finalized and presented to NBY management.

Met Partially Met Not Met

- Advisors will have participated in at least a second on-site inspection

Met Partially Met Not Met

- An outreach seminar with banking and accounting community focusing on prudential regulations and regulatory reports will have taken place.

Met Partially Met Not Met

Within 180 days

- Procedures for offsite analyses will have been drafted in conjunction with NBY officials and instructional materials developed and presented to inspection staff

Met Partially Met Not Met

- The second set of three chapters of the on-site inspection manual will have been drafted by the NBY working group, classroom training will have been held on these chapters, and testing of the procedures will have been done during on-site inspections.

Met Partially Met Not Met

- Advisors will have participated in at least a third on-site inspection

Met Partially Met Not Met

Within 240 days

- New regulatory report formats will have been drafted and presented to NBY management. Training in the new offsite analysis procedures will have been provided.

Met Partially Met Not Met

- Advisors will have participated in at least a fourth on-site inspection.

Met Partially Met Not Met

- Advisors will have helped NBY establish an annual inspection schedule of banks based on priorities.

Met Partially Met Not Met

* The bank strategies will be the driving force of the annual inspection schedule of banks. These strategies will be completed by the end of the month of March 2003.

- The third set of three chapters of the on-site inspection manual will have been drafted by the NBY working group, classroom training will have been held on these chapters, and testing of the procedures will have been done during on-site inspections.

 X Met Partially Met Not Met

- Continued training in the new offsite analysis procedures will have been provided and the new analysis procedures will have been implemented.

 Met X** Partially Met Not Met

*** As new manual segments on examination procedures are developed continued training is taking place. This is not a process with a specific end. The examination procedures manual and resulting training is a dynamic process.*