REPORT ON OPERATIONAL AND FINANCIAL SUSTAINABILITY CONSULTATIONS

BOSNIA AND HERZEGOVINA

PARTS ONE AND TWO:
Entity Banking Agencies
State Deposit Insurance Agency

Prepared for USAID by
The Financial Services Volunteer Corps

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ABBREVIATIONS USED IN THIS REPORT

BiH	Bosnia and Herzegoviza (the state)
CBBH	Central Bank of Bosnia and Herzegovina
DIA	Deposit Insurance Agency
FBA	Federal Banking Agency of FbiH
FBiH	The Federation of Bosnia and Herzegovina
FSVC	Financial Services Volunteer Corps
RS	Republika Srpska
RSBA	Banking Agency of the Republika Srpska
USAID	United States Agency for International Development

Participants in the assignment and report preparations

FSVC staff:

Anthony Randazzo, Regional Director for FSVC

Almir Jazvin, Program Officer, FSVC in BiH

FSVC volunteers:

Robert Porter – Team Leader, Part One, Entity Banking Agencies

Robert Lyon

Geary Vance

Keith Siebold – Team Leader, Part Two, Deposit Insurance Agency

NOTE: While the assignment was initially organized into two teams for the two parts to be covered, there was extensive interaction among all four volunteers, and this report is being presented in four parts to cover the issues raised within both parts.

EXECUTIVE SUMMARY

Introduction

The FSVC has been asked by USAID to provide a team of volunteers to undertake Operational and Financial Sustainability Consultations within BiH as to: 1) entity banking agencies; and 2) the State Deposit Insurance Agency (DIA). A team of four volunteers worked on-site in BiH from January 13th through the 27th. While some of the work was done on the two areas separately, there was extensive coordination among all team members, and thus this report represents the combined conclusions and recommendations for both segments.

Concept

The team has understood that USAID wishes to have a successful "exit strategy" from its significant contribution to the BiH's banking sector. This exit strategy is based on sustainability of the institutions presently having supervisory roles in the BiH financial sector. The team's efforts have been to help consider how best to sustain banking supervision and deposit insurance in BiH and recommend to USAID a "how to get there" strategy.

Based on this approach, the team has determined two main priorities as to sustainability. While there are many other findings, conclusions, and recommendations from our work, we wish to focus the attention of USAID on these two main priorities and the "how to" steps to achieve them.

Priority Number One:

Banking supervision is not sustainable with the present entity level banking agencies, especially one agency that is not close to being financially viable. As such, the team strongly recommends the two agencies be fully integrated in the CBBH (the Central Bank of BiH) within a time frame up to 30 June 2004. The CBBH Governor supports this move, and a broad consensus seems to have developed for this integration.

Priority Number Two:

The newly established Deposit Insurance Agency (DIA) is not at present performing the key function of "resolution" of problem/failed banks, as this role presently resides in the entity banking agencies. Also, the legal framework appears to be inadequate for the DIA to assume a "receivership" role for such banks, as is a key power for the American FDIC. The long-term success of the DIA and preservation of its insurance fund depends on a sound resolution function within the DIA and sufficient legal powers as receiver to protect the insurance fund.

<u>Strategy as to "how to get there" for the main priorities</u>

USAID has emphasized to FSVC the importance of providing a "how to" approach as to the priorities needed for a successful exit strategy. As such, a large portion of this report indicates specific steps to achieve the exit strategy and sustainability, especially as to the two main priorities.

This report gives a matrix approach to assist USAID in its "how to" for achieving an exit strategy. The four matrixes provided each contribute steps to advise USAID for the upcoming period leading to its exit from banking sector assistance. They are as follows:

1. **MATRIX OF TECHNICAL ASSISTANCE** (given at the end of this executive summary). This matrix lists all suggested TA components as recommended to USAID over a period ending 30 June 2004. The TA listed supports all the areas the FSVC team believes should be covered, and it is listed by priority.
2. **MATRIX OF "HOW TO" STEPS FOR BANKING SUPERVISION INTEGRATION INTO THE CBBH** (given in Part One, page 14). This matrix lists all steps needed to achieve integration of the banking supervision agencies into the CBBH by 30 June 2004.
3. **MATRIX OF "HOW TO" STEPS FOR HUMAN RESOURCE ISSUES** (given in Part Three, page 25). This matrix lists all steps and issues regarding human resources and "change management" as to integration of banking supervision into the CBBH and as to the DIA.
4. **MATRIX OF "HOW TO" STEPS FOR THE DIA AS TO RESOLUTION AND RECEIVERSHIP** (given in Part Four, page 33). This matrix lists steps needed as to the essential areas of resolution and legal powers of receivership.

<u>Roadmap as to use of this report</u>

While efforts have been made to standardize this report, it should be kept in mind that the four parts in the main body were written by four different FSVC volunteers all making their contributions as to findings, conclusions, and recommendations. An important example is Part Two, which contains a very useful evaluation of the banking agencies at present and their needs. Several recommendations, somewhat outside the two main priorities and their *how to* steps, are contained in this part of the report.

Each section is organized as to findings, conclusions where applicable, and recommendations. All sections except Part Two have an aforementioned "how to" matrix. Attention is also drawn to Annex 3, which explains the models used for the structure of banking supervision. Annex 3 supports the recommendation that given the present BiH banking sector, supervision should reside in the central bank.

The Matrix of Technical Assistance, which is the key part of "how to" steps, is on the following page.

MATRIX OF TECHNICAL ASSISTANCE TO IMPLEMENT USAID EXIT STRATEGY

The main part of the "how to" as to implementing USAID's exit strategy is well focused technical assistance (TA). In order for this TA to succeed all advisors need to be committed to the objectives that have been set and to the completion date. Parts one, three, and four within the main report each give a matrix as to all steps within the topic discussed in that part of the report. The matrix below gives a broader view of all TA suggested for the remaining period. The TA is listed **by priority**; thus if USAID cannot fund all areas, it is suggested the lower topics be cut first.

TA EXPERT	START AND COMPLETION DATE	SKILL SET REQUIRED	KEY COUNTERPARTS	COMMENTS
1) Coordinator	Entire period: March 2003 through June, 2004 (resident)	Central banking, bank supervision deposit insurance, and excellent people skills	CBBH Governor, Heads of Banking Agencies, Head of DIA, all members of Strategic Working Group	Potential candidate is existing U. S. Treasury Advisor, given that his revised ToR would allow this and his familiarity with all areas
2) Legal expert for financial sector	April 2003 through Feb. 2004; periodic visits – estimate of 5 man months	Legal as to laws and regulations for central banking, bank supervision, and deposit insurance, esp. resolution and receiverships	CBBH Governor, Heads of Banking Agencies, Head of DIA, all individuals involved in legislative process	Main work should be complete by year-end 2003, though some assistance in early 2004 may be needed
3) Bank resolution expert	April 2003 through April 2004 (one year resident)	FDIC expert as to bank resolution and receivership, including liquidation experience	Head of DIA, CBBH Governor, Head of Banking Agencies	This is viewed as major topic, thus requiring a one year resident
4) Human resources (HR) expert	April 2003 through May 2004; periodic visits – estimate of 9 man months	Senior HR management experience, including *change management* experience	CBBH Governor, Heads of Banking Agencies, Head of DIA	This could be divided into two topics: one to set up HR function in CBBH and the other to facilitate change management
5) IT expert	June 2003 through March 2004; periodic visits – estimate of 4 man months	Data base management and information sharing via intranet among RSBA, FBA, DIA, and CBBH	Head of DIA, CBBH Governor, Heads of Banking Agencies	Higher priority as to DIA needs and would improve functionality and usage by FBA and RSBA. Grant for purchase of hardware and software
6) Specialist in new banking risks and training	September 2003 through June 2004; periodic visits – estimate of 3 man months	Training/teaching in market risk and operational risk plus ensuring on-going internal training	CBBH Governor and Heads of Banking Agencies	This work could potentially include a review to streamline reporting requirements imposed on banks

PART ONE: Integration of Banking Supervision Agencies into CBBH

Overview

An essential part of an overall exit strategy for USAID as to the banking sector of BiH is to ensure the sustainability of the supervisory activities it has so generously supported for six years. The initial USAID hypothesis as to how to achieve this has been to call for and help implement transition from the existing entity level banking agencies to being under an "umbrella" within the CBBH. The CBBH Governor in a discussion paper to his own Governing Board first raised the umbrella concept in October of 2001. Other issues and other points of view sidetracked this initiative in 2002, and the FSVC team has been asked to review this topic and make recommendations, including specifics as to implementation.

The team has interviewed senior representations from the various "stakeholders" as to banking supervision in BiH and studied a large amount of documents made available. The team is recommending USAID not only call for the umbrella concept within the CBBH but to go further by urging full integration of banking supervision into the CBBH, with the only caveats being that the DIA and non-banking financial sector supervision be outside the CBBH (as they are not proper central banking activities). Extensive discussions with the CBBH Governor make clear he supports this step and wishes to move forward via the already existing *Strategic Working Group* he now chairs.

The remainder of part one gives the findings (both general and from the four stakeholders) followed by conclusions and a detailed list of recommendations. *A matrix giving the suggested benchmarks for implementation of the integration objective follows this part. The matrix represents the "how to get there" aspect of the recommended integration.* The final part of this section briefly covers conditionality, given what the team understands USAID's leverage is at present.

Findings

General Findings:

The most important findings are listed below – they are taken from the more detailed findings of the four "stakeholders" (FBA, RSBA, CBBH, and commercial banks) that follow these general findings.

1. There is no adamant opposition to integration of the banking agencies into the CBBH from the interested parties in the BiH banking sector, nor does there appear to be any insurmountable obstacles

2. Financial sustainability for banking supervision will be greatly improved by integration into CBBH, especially given the situation with the RSBA (see next point)
3. The RSBA is not a sustainable banking supervision agency given its extremely weak financial situation, tiny banking sector, and unstable (to date) management
4. Political independence and operational efficiency of banking supervision will both be improved via integration into the CBBH
5. The supervised banks strongly favor integration into CBBH
6. Banking supervision at the state level within the CBBH will enable BiH to take full advantage of numerous international and regional supervisory contacts as to coordination and training, which has not been available to any significant extent to date due to entity level supervision
7. The case that has been made for a new agency outside the CBBH based on "unified financial sector supervision" is marginalized by the tiny level of non-bank activities at present (see Annex 3 for much more detail on this issue)

Findings by Stakeholder:

FBA

- The six year existence of FBA has resulted in reasonably capable banking supervision for the level of sophistication of the FBiH banking sector
- The management of FBA would ideally like to increase staff size but agrees its main tasks are being met by present staff
- The emphasis within the FBA is on traditional day-to-day supervision using off-site and on-site examination methodologies (cross reference to part two)
- Far less emphasis and manpower has been given to the *resolution* function of provisional administration and liquidation (cross reference to part four)
- Staff turnover has been virtually non-existent the six year history of the FBA
- Senior management supports an "umbrella" attachment to the CBBH but opposes a full integration of FBA staff becoming CBBH staff – thus they do not wish to lose their present identity and positions
- Middle level management appears more comfortable with full integration into the CBBH
- Middle level management notes that banking supervision in BiH has not benefited from extensive international banking supervision contacts due to the two entity arrangement and hopes this would change under a state-level supervisor (this was noted in the RSBA as well)

RSBA

- The model for supervision is virtually identical to the FBA as to legal framework and operations but on a far smaller scale

- The RSBA is clearly not financially sustainable nor will it be in the future as presently structured
- The RSBA has not had a stable management history, and the present director remains in her post on an acting basis
- While overall cooperation exists between the FSA and RSBA, coordination as to their roles, authority, and activities with banks operating in both entities could be improved (cross reference to part two)
- The banking sector within the RS is simply too small and too weak to justify a sustainable separate banking supervision agency
- RSBA acting management is highly focused on solving short-term premises and equipment needs, in contrast to having a firm longer term view as to structure
- Related to the above point, RSBA acting management will not oppose integration into the CBBH provided there is significant branch level operations in Banja Luka that includes banking supervision activities
- RSBA management feels any political obstacles or reluctance as to integration into the CBBH could be overcome, but this may well require close dialogue and persuasion from the CBBH Governor with leading RS politicians

CBBH

- The CBBH has operated with very good success as a tightly restricted Currency Board
- The Governor of the CBBH is the most respected official in the banking sector, and his stature is clear among all key banking sector participants – his continuation as Governor past his current term is not yet determined but appears likely
- The Governor proposed a framework to his own Governing Board in October, 2001 as to an umbrella arrangement for bringing banking supervision under the CBBH
- This proposal was sidetracked in 2002 due to other priorities and differing views as to a potential unified supervisory agency or a go-slow approach based on coordinating committees involving the present participating institutions
- The CBBH, by its natural currency board operations, is easily capable of sustaining the costs of banking supervision
- The Governor is of the view that at present there is an extremely small non-bank financial sector (insurance, securities, etc.) and that areas such as securities may best be regulated on a regional basis to include BiH with its neighbors
- The CBBH is satisfied with its political independence
- The Governor states that in small and underdeveloped banking sectors the model of supervision within the Central Bank generally works best
- The Governor is of the view that if a consensus is reached as to integration of banking supervision in the CBBH, the transition can be done quite quickly

- Legal framework issues as to banking supervision moving to the CBBH may be somewhat more difficult in the RS as compared to FBiH, but the recent legislation as to the DIA set a good precedent
- The Governor favors integration of banking supervision into the CBBH; he wishes now to move forward with this process and will welcome USAID assistance on this
- The Governor wishes to initiate the process through the existing *Strategic Working Group* that he now chairs

Commercial Banks

- The banks recognize that the FBA has developed into reasonably competent supervisors with recent progress noticed
- Banks operating in both entities feel there is an excess amount of formality and bureaucracy with some duplication of supervisory efforts by the two agencies
- Banks feel there is an insufficient appeal process to supervisory rulings by the heads of agencies
- The FBA is not presently capable of supervising the more sophisticated banking products entering or soon to enter BiH
- Relations with the CBBH are smooth and professional, mainly due to the stature and competence of the Governor
- One bank feels the FBA was arbitrary as to calling for increased provisions when its external auditor was following IAS guidelines (cross reference to part two)
- Banks feel the present reporting burden to the agencies is excessive, especially for banks operating in both entities
- Banks with majority foreign ownership would like to see better links between BiH supervision and the supervisors in their home country and feel a state level supervisor will be needed for this to happen
- Banks appear to strongly support integration of banking supervision into the CBBH, as many of their above points would likely be improved – especially as to efficiency, fairness, and sound judgment

<u>Conclusions</u>

Based on the above findings, the FSVC team has come to the following conclusions

1. Banking supervision in BiH would be much better performed at the state level
2. Institution building in BiH has been difficult, time consuming, and not always successful, thus integration into a state level entity that is already well established and respected is far preferable as compared to creating a new institution
3. The CBBH, as presently operating, is ideally suited to take over the responsibility for banking supervision and this would be best done via full integration

4. While the CBBH should take over banking supervision, it should not assume the role of resolution (liquidation) of banks nor should it supervise the non-bank aspects of the financial sector
5. To cover the related issues of banking supervision not directly done within the CBBH there will need to be an "Advisory Committee" of interested parties to meet at least semi-annually with membership reflecting all key elements of the overall financial sector
6. Prior to the full integration of banking supervision into the CBBH there will need to be a "transition team" to ensure smooth integration of banking supervision into the CBBH taking into account the views of all interested parties – this transition team should be an outgrowth of the existing *Strategic Working Group,* where the process should begin

Recommendations

The recommendations given below are consistent with the above findings and conclusions:

1. The top priority of USAID's 18 to 24 month "exit strategy" as to the BiH banking sector should be to strongly promote and then help facilitate a full integration of the two existing entity banking agencies into the CBBH with a deadline of no later than 30 June, 2004 for completion of this integration
2. The blueprint for such integration is largely contained in the Governor's own 2nd October, 2001 draft discussion paper to his Governing Board
3. Full integration of the banking supervision agencies should consist of all staff and management of the existing agencies becoming CBBH staff members without loss of compensation and with functions/duties in line with present tasks
4. The CBBH Governor should become the senior banking supervisor in BiH with oversight being vested in the CBBH Governing Board. Below the Governor should be a new Vice Governor (Deputy Governor) in charge of the day-to-day banking supervision function. The present Director of the FBA could be considered a candidate for this new Vice Governor position
5. Banking supervision issues and activities should be a regular agenda item at all meetings of the CBBH Governing Board
6. The duties and personnel of the present RSBA should be integrated into an expanded Banja Luka branch of the CBBH, to include both banking supervision and currency board operations. The head of this significant branch should be at the same level as to compensation and authority as the Vice Governor for Banking Supervision, with both reporting directly to the Governor, though, of course, cooperation between the two on banking supervision aspects is essential. The Acting Director of RSBA would be a logical candidate for such a position.
7. While the traditional banking supervision duties and authorities should be fully integrated into the CBBH as described above, the resolution (liquidation)

function now in the agencies should be shifted to the DIA and not a function of the CBBH (this topic is covered in Part Four of this report)

8. The CBBH should not perform supervisory functions of the financial sector outside of banking supervision but should ensure coordination of all financial sector supervision element (insurance, securities, etc.) through an "Advisory Committee"
9. The Advisory Committee should meet at least semi-annually, chaired by the CBBH Governor and include membership, at a minimum, from the DIA (its Director) and representatives of all other financial sector supervisory bodies such as insurance and securities
10. The Advisory Committee would eventually replace the existing working groups at a strategic and technical level.
11. The first step of this process, as preferred by the CBBH Governor, is to use his existing *Strategic Working Group* to form a consensus – it is anticipated this would then shift to a "transition team" to implement the integration of banking supervision into the CBBH
12. USAID will need to closely follow a set of benchmarks which will be the "how to" steps in order to achieve a 30 June, 2004 target date for completion
13. Remaining USAID technical assistance, specifically as to funded advisors, should be refocused in order to target the main objective of integration of banking supervision into the CBBH (see Matrix of Technical Assistance) as well as TA needed for the DIA

Benchmarks – Matrix as to "How to Get There"

In order to meet the main objective of full integration of banking supervision into the CBBH by 30 June, 2004, a broad set of steps to guide the work ahead are needed.

The following page is a matrix giving these steps as benchmarks. These are consistent with the conclusions and recommendations given above.

Matrix on *"How to"* steps for integration of banking supervision into CBBH

TOPIC	COMPLETION	T. A. REQUIRED	COMMENTS
USAID presents its views and suggestions to interested parties, and CBBH Governor discusses with his Strategic Working Group	31 March, 2003	Coordinator (see TA matrix) can assist in this initial step	USAID should discuss thoroughly with the Governor of the CBBH as to how he wishes to proceed
Establishment of a transition team after agreement by the Strategic Working Group	30 April, 2003	USAID Coordinator can either join or advise this transition team	Transition team will be an outgrowth of Strategic Working Group
Legal drafting of all changes needed in framework for CBBH supervision	31 July, 2003	USAID Advisor with legal skill in drafting financial sector legislation	See Matrix of TA for role of this legal advisor – this is the first part of the work
"Change management" task of preparing staff of agencies and CBBH for staff integration	31 December, 2003	USAID Advisor who is an HR specialist	See Matrix of TA for role of this Advisor
Passing or amending all required changes to legal framework	29 February, 2004	USAID legal advisor to help "Shepard" this process	This is the 2nd part of the work of the legal advisor
Final steps on change management and human resource needs	31 May, 2004	Second part of work of HR Advisor	As shown in Matrix of TA
Completion of the integration of the banking supervision function into CBBH	30 June, 2004	Coordinator to help 'wrap up' final steps working with all interested parties	At this point the recommended Advisory Committee should be in place

Conditionality

As understood by the team, USAID desires to impose conditions in order to see its exit strategy be carried out. The team is aware of only two "levers" available to USAID as to imposing such conditions. These are listed as follows:

Short-term condition – funds set aside for RSBA infrastructure. It is understood that USAID has set aside KM 4 million to assist the RSBA as to transition to new premises and office equipment (computers other IT support, etc), but these funds are not yet committed. There is a view that the RSBA and the RS in general will be the least enthused as to integration of banking supervision within the CBBH (however, the discussions at RSBA did not indicate significant opposition). In any case, the release of any or all of the KM 4 million funds should, at a minimum, be contingent on all applicable authorities within the RSBA (or connected to it) supporting the move to the CBBH first verbally and then subsequently signing the suggested MoU. If possible, disbursement of the allotted funds for the RSBA should be in stages to ensure full cooperation from the RSBA side as to banking supervision within the CBBH. If the above timetable is met, full release of such funds could be as early as 30 June of this year.

Long-term condition – linkage of any further USAID technical assistance (TA) to integration of banking supervision within the CBBH. It is understood that committed funding for USAID technical assistance expires very soon – the end of February. While the TA given to date within the two banking agencies has been helpful, it is recommended this TA be significantly refocused to serve the exit strategy, with a main part being to facilitate the integration of banking supervision into the CBBH. The TA Matrix to this report describes the recommended skill set for future technical assistance. To the extent possible, USAID should provide such TA in stages, giving it the option of withdrawing TA if progress is not made as to its objectives under the exit strategy.

Part Two: Concise Evaluation of Banking Supervision Agencies and Their Needs

Overview

Significant reduction in the number of banks within BiH has occurred over the past several years as a result of merger, acquisition, voluntary or involuntary liquidation, and bankruptcy. Within the FBiH, the current (December 31, 2002) banking structure reflects 27 banks, with aggregate assets estimated at KM 4.6 billion. Due to DIA membership requirements, it is expected that the number of banks will decrease to 20 by year-end 2003. Of these 20 banks, 18 would be considered active, as two banks have limited activity. Within the RS, there are 10 banks, with estimated assets of KM 900 million; expectations are that the number will reduce to between 5 and 7 because of DIA membership requirements.

1) Observations of Bank Supervision Effectiveness

Findings

Both the FBA and RSBA have effectively met their bank supervisory responsibilities. Each has a seasoned staff, has received significant amounts of training, both classroom seminars and via on-site examination participation or leadership from USAID advisors. Further, senior management of the agencies have benefited from the expertise of and interaction with, fulltime on-site advisors. The examination process – the pre-planning of the exam, utilization of off-site analysis, rating evaluations submitted to each respective agency's internal supervisory board, the examiner's proposal for future supervisory strategy, the finalized examination report, and the resultant presentation of the exam report to the examined Bank's Board of Directors - is sound and logical. The investment made by the banking agencies (and USAID) in the training of examiners has been substantial.

Recommendation

In the interim period and upon integration into CBBH, the FSVC team recommends that efforts are made to ensure that the agencies do not lose key management personnel as well as experienced examiners as such loss would seriously impact the ability for effective bank supervision.

2) Examination Timeliness

Findings

Both the FBA and RSBA (the Agencies) have prioritized examiner resources by focusing on the weakest banks (those rated composite 4 or 5), for full scope exams and follow-up activities via tracking compliance with orders. Both agencies have placed significant reliance on off-site supervision and analysis and utilize such information for follow-up and re-prioritization of both full-scope and targeted examinations. Examination resources have been devoted over the past several years dealing with problem banks and resolution of others. As a result, neither agency has been able to examine all banks on a regular cycle (such as every 12 months), relying heavily on the quarterly off-site analysis for "high-risk" banks and to maintain knowledge of activity and trends within the less troubled banks. Examination resources have also been devoted to ensuring compliance with new laws (anti-money laundering) and various ongoing requests for information from the Ministry of Finance, Finance Police, and others. Given the above workload, the FSVC team recognizes the requirement to balance resources and understands the decision to historically focus on problem banks.

During 2002, the FBA performed 13 full scope exams, numerous other targeted exams, and examination assistance for 7 banks under provisional administration. Within the RSBA, during 2002, 6 full scope exams were completed, a variety of targeted examinations performed, and other follow-up activities. During 2003, RSBA plans a full scope exam of all banks, while FBA plans on full-scope exams of 9 banks and a number of target exams.

Recommendations

Both agencies should strive for examining each bank on at least an annual basis, especially in view of consolidations and rapid growth relative to banks under FBA jurisdiction. If appropriate, the FSVC team recommends that streamlining of examination procedures occur, while still allowing proper review of the critical categories of capital, asset quality, earnings, and liquidity.

3) Information Provided by the Banking Agencies to the Deposit Insurance Agency

The DIA relies upon the banking agencies for information and analysis in their determination of appropriateness of membership admission to the DIA. Such information and analysis from the banking agencies should be relatively current to ensure that potentially failing banks are not admitted to membership.

Recommendations

1. In view of the need for the DIA to approve membership applications by August 2003, the FSVC team recommends that the agencies ensure that applicable banks, those yet to receive membership, have a current (within past 12 months) exam by July 15, 2003, to provide the DIA to use in its decision making process.

   The exams should focus primarily on capital, asset quality, sufficiency of reserves, earnings sustainability, and liquidity.

   Banks, which may have recently undone a significant reorganization, a significant acquisition, or rapid growth, should be re-examined.

2. The FSVC team recommends that an agreement on the exchange of information between the banking agencies and the DIA, which specifies the types and timing of information to be shared between the entities, should be formulated and immediately adopted.

3. Informal, perhaps quarterly, meetings between the DIA and the banking agencies/CBBH should occur to discuss emerging trends and other matters of mutual interest.

4) Centralized Information Sharing

Findings

RSBA and FBA rely heavily on the various reports submitted by banks for off-site analysis and to some extent as an early warning system. The agencies are in different stages as to their development of databases to store and share such information. It is the FSVC team understanding that the FBA internal bank supervision IT system lags somewhat behind that of the RSBA. The RSBA has established a successful database reflecting a significant amount of historical data, examination reports, orders, etc. Such information is available to examiners via a shared network and is user friendly with favorable functionality. RSBA staff indicated a willingness to share their technology and development with other interested parties, such as the FBA. However, they indicated that new software, a new server, and updated computers are necessary in order for the system to remain stable. The DIA would also have an interest in bank financial data.

A significant number of reports are required to be filed by banks to their respective banking agencies, estimated at 43, either daily, weekly, quarterly, etc. Banks have indicated a substantial amount of time is necessary to complete such reports, noting that some are redundant, and questioning the usefulness of others.

Recommendations

1) The RSBA system of storing bank data and accessibility of such data to necessary users should continue advanced development, and its platform adopted by FBA as a shared resource application (SRA). Under a SRA, a user group determines future necessary needs, and such development costs and maintenance costs are shared among users.

2) A user group of representatives from the RSBA, FBA, CBBH, and DIA should be immediately formed to determine the optimal functionality of a centralized information system.

3) Provision of an estimated $75,000 of hardware such as a server, PCs, and accompanying software should be provided by USAID, and obtained locally to ease any repair needs.

4) Realization of the above recommendation would serve to facilitate a centralized intra-web database, which could be shared with other interested parties, especially the DIA which has a need for the analytical data. Access to information can be restricted to a "need to know" basis with log-on and password procedures.

5) A review by the banking agencies of the various reports filed by banks should be conducted and a rationalization of the continued necessity and importance of each. Such review should be joint with the DIA and Central Bank, as these entities also require various reports. When possible, reports should be combined or eliminated, so that there is consolidation of reporting requirements and the regulatory burden placed upon banks is reduced, increasing the efficiency of both the banking community preparing such reports and agencies which may be reviewing and storing unnecessary reports.

5) Sharing of Examiner Resources

Findings

RSBA and FBA, on occasion, due to geographic locations, examine banks located closer to the other agency's headquarters. Due to the decreasing number of banks within the RS, some examiner resources there may become available for other purposes.

Recommendations

1. The RSBA and FBA should agree to share examiner resources whenever possible and should engage in joint scheduling practices to accomplish this. While each agency should supply the EIC, if an exam is closer to the other agency's headquarters, those examiners should be used whenever possible to maximize efficiency. If one agency has a staffing need, they should temporarily "borrow" examiner(s) from the other agency.

6. Human Capital Management

Findings

When the reorganization of the RSBA and FBA under the CBBH occurs, whereby the two agencies were either combined or activities consolidated, staff reductions could occur, or resources freed up for other activities, such as more frequent full-scope and targeted examinations, training, and further IT development.

For example, it would not be necessary to maintain separate legal, licensing, liquidation, IT, and administrative functions at each location. Further, department heads, supervisors, managers, would not need to be duplicated.

Recommendations

1. Staffing requirements of both agencies must be critically examined, with necessary skill sets defined.
2. Rationalization of existing positions must be made. For example, can a vending machine replace the person who provides coffee and washes the dishes? Is it necessary and cost justified to retain a vehicle and driver?
3. An H.R. function dedicated to developing an appraisal and compensation framework should be implemented, and responsibilities for training coordination assigned.
4. Specialized English language training should be provided so that examiners can communicate with other country supervisors during joint examinations and to maximize knowledge gained from training provided in other countries.
5. As the banking sector increases in complexity, the development of subject matter experts (SMEs) should be considered. SMEs should be seasoned examiners interested in becoming expert in activities such as insurance, securities, investment analysis, EDP/IT activities. They would be responsible for teaching and training others, and participate on exams.

Part 3 – Human Resource Issues and Training Needs of Banking Supervisors

Overview

The Federal Banking Agency (FBA) and the RS Banking Agency (RSBA) currently have 47 and 34 employees respectively, with approximately one-third of the staff involved with on-site and off-site supervision. Each agency is identically structured as to organization, although the RSBA currently has no deputy director in place. Also, the director of the RSBA is "acting" as was her immediate four predecessors.

The FBA is authorized by law to employ up to 61 persons. The same law also provides a general job description for the 61 positions. No such law was discovered pertaining to the RSBA. Neither agency employs a full-time training staff.

1) Bank Risk Assessment Skills (Part Two above expands on this topic.)

Findings

The USAID bank supervision technical assistance program, which has been in place since 1996, has generally been successful in preparing the FBA and the RSBA staff to properly assess risks in banks, recognizing that the banking system in FBiH and in the RS are still somewhat undeveloped.

Recommendations

During the remaining term of the project, additional training would ideally be needed to address new banking products and services as they are introduced and evolve. For example, additional training will include risk assessments associated with the introduction of a government securities market and presumably the addition of such securities to the asset portfolios of banks. Also, the RS supervision department heads stated that banks there are introducing securities services for their clients and they believe their staff needs basic training on how to assess the operational risks associated with these services.

In addition, training related to expanding electronic banking and Internet banking services will be needed.

Benchmark

Please refer to the Matrix of Technical Assistance item number six contained in the Executive Summary.

2) <u>Internal Training</u>

Findings

There appears to be little emphasis on internal, formalized, on-going training, especially of the on-site inspection staff. A "train the trainer" workshop was conducted under the current TA program, but this workshop primarily addressed "how to teach" in a classroom setting more than "what to teach". Fortunately, there has been virtually no staff turnover in on-site and off-site staffs, thereby lessening such internal training requirements. It cannot be assumed that this good fortune will be permanent.

It is financially impractical to create a full time training department.

Recommendations

Please refer to the Matrix of Technical Assistance item number six.

At least one highly skilled person in each appropriate department should be designated as a "Trainer." These designated persons should be selected, not only based on their technical competence, but also by a superior aptitude as a teacher. For this special designation, that person should also receive a higher job category designation. (More on the concept of developing job categories later in this report.)

The designated *trainer(s)* would be selected to attend applicable out of the country seminars and workshops which are conducted by various international agencies and centers of learning. These attendees would then be expected to teach what they learned at those seminars to the full staff of the applicable departments in a classroom setting. Because most international training seminars are delivered in English, with to a lesser degree German, the designated trainers will have to be fluent in one of those languages.

3) <u>Change Management</u>

Findings

Should the recommended structural and reporting changes for the banking supervision function be accepted, there would be a high level of anxiety among the current staff of the respective banking agencies. It is possible, perhaps probable, that this anxiety could result in the loss of key personnel, thereby reversing much of the good training that has been achieved.

While the FBA staff members generally accept the idea of the possible changes recommended (not so much agreement was expressed by the RSBA staff), a specific concern about compensation levels was noted. To a lesser degree, concerns about changes in office space and accommodations were expressed.

Recommendations

Please refer to the Matrix of Technical Assistance item number four.

Once it is clear the structural and reporting changes will occur, a series of workshops should be held with all staff members of the FBA and RSBA to explain how the changes will affect them. These workshops, which should be conducted very soon after the changes are announced, should also focus on why these changes are necessary, i.e., how the changes will improve the long-term prospects for a sound banking system.

The specific concerns listed above (compensation and premises), as well as any other concerns that develop, should be included in the workshops.

Not necessarily specifically related to *training*, but in cases where it becomes apparent that the elimination of jobs will occur (if any), policies and procedures should be developed regarding outplacement benefits. These benefits should be intended, not only as a means of "softening" the harsh reality of losing a job, but also as an incentive to retain employees through the transition period of the changes. Those employees affected should be individually counseled as soon as the decision is made to eliminate his or her position.

4) <u>Human Resource Function</u>

Findings

It is apparent there are little or no formal human resource (HR) policies in place in either agency. While there are basic job descriptions provided within the "Regulations on Designation of Duties" document from Article 22 of the Statute of the Banking Agency of the Federation of Bosnia and Herzegovina, it is questionable if these job requirements are followed. When asked who manages the HR function, FBA staff members said those duties lie with the Director of the Agency.

According to Governor Nicholl of the CBBH, the HR function at the Central Bank is undeveloped and he would like to see it expanded. He described "salary bands" as the extent of a salary administration process. He would like to implement a job evaluation process coupled with a more formal performance measurement program.

Recommendations

Assuming the Agencies become integrated within the Central Bank, a HR function should be created or enhanced.

Specifically:

- There should be comprehensive job evaluation and performance measurement procedures developed.
- A formal salary administration function along with a career progression process should be implemented.
- Formal training duties should be added to appropriate departments as described above.

Benchmark

Please refer to the Matrix of Technical Assistance in the Executive Summary.

The contractor will provide TA to assist in developing the above policies and procedures within twelve months of the Agencies being integrated within the Central Bank.

The matrix on the following page presumes a general agreement to integrate the FBA and the RSBA into the Central Bank is achieved along with conceptual agreement on the transfer of the problem bank resolution function to the DIA.

Matrix of "How To" Steps for Human Resources Issues

TOPIC	START-COMPLETE	T.A. REQUIRED	COMMENTS
Initial discussions with all interested parties as to combining the individual organizations into the CBBH.	March -April, 2003	USAID contractor/advisor to act as a coordinator of the discussions.	Discussions should be with the FBA, DIA, RSBA, CBBH and other interested parties including the DIA advisors.
Draft of checklist of HR issues completed by a working committee representing each organization.	April-May, 2003	USAID contractor/advisor facilitates this process. This person should have HR and/or "change management" skills.	Each organization should have a "senior" staff member participate in these discussions.
Resolution of HR issues and questions.	April-May, 2003	Same as above.	Critical issues: Salary stability and staff reductions (if any).
Staff discussion groups conducted to alleviate fears and concerns regarding the changes.	June-July, 2003	Same as above.	All employees of all affected organizations to attend these discussion groups.
Establishment of a formal HR department/function within the CBBH.	June, 2003-March, 2004	USAID provides advisor via contractor. The advisor should have senior management HR experience.	Deliverables: written HR policies, formal job descriptions, performance measurement/ feedback process, salary administration program.
Establishment of ongoing internal training process.	January-May, 2004	USAID advisor who is a HR specialist in such processes. This advisor may or may not be the same person as listed above in this table depending on the skill sets of the advisor.	Concentration should be on identifying bank inspector trainers and establishing specific training duties and procedures, including how to implement additional training for new financial risks as they emerge in the market.

PART FOUR: Deposit Insurance Agency and Problem Bank Resolution Function

Overview

The Deposit Insurance Agency was officially authorized by law and established in August 2002. The staff of this organization is in the formative stage with limited resources and total personnel of 14. The DIA broad objective is to promote financial stability, protect depositors' interest and enhance public confidence in the banking system.

The overall strategy of this project is to produce an outline for sustainability of this agency and direction to provide the means to operate independently. The recommendations and benchmarks are also intended to provide some degree of measurement for technical assistance that may be required to monitor progress in achieving these goals.

The initial financial capital for this organization was contributed by USAID and GTZ and thus far the agency has operated on a budget within the confines of the resources allocated by law. As such, funds for needed capital improvements will likely depend on additional donor support.

The agency has placed the highest priority on bank analysis/monitoring in conjunction with the defined period for deposit insurance membership. That period expires by law on August 13, 2003.

The liquidation function is currently the responsibility of the two entity banking agencies (FBA and RSBA) by law. The DIA fund is the largest claimant for failed bank liabilities and maximum recovery of these assets is critical to maintaining the insurance fund. In other words, the DIA is the largest and most significant stakeholder in the liquidation of failed bank assets.

Also, the present law regarding failed banks does not give the DIA the essential receivership role for orderly liquidation of the failed bank assets.

I. Findings – Lack of Payout Function

This organization has not developed the depositor payout function to any extent. There are no written procedures for this function and the agency as such has not conducted a payout. The present policy, according to the GTZ Advisor Mr. Mueller, is to contract / outsource this function. This is not a cost effective solution to a critical function with the limited financial resources of the Agency. Current law allows 60 days to complete a payoff of a failed bank. Interviews with advisors Demler and Mueller, Governor Peter Nicholl and a small sampling of Bosnian citizens, indicates this may be a reasonable expectation for timely access to deposits of a failed bank. No one individual within the organizational structure has a defined responsibility for the payout function. It is recognized that the present staff is small and limited by law to 14 persons.

Recommendations

This is an area that will require technical advisor follow-up to ensure procedures are developed, training is conducted, and automation is utilized to the maximum effect. When preparing the payout procedures, the following are items to be included in the procedures.

1. A member of the existing staff should be assigned responsibility to assist in development and lead the team in conducting a payout event.
2. During a payout process, the DIA should be as cost effective as possible and should utilize existing staff and other government resources, including the banking agency.
3. Payoff function should be timely. Current law allows 60 days to complete a payoff. However, an efficient and timely process would enhance confidence in the deposit insurance system and the BiH banking system. Future goals should be a reduction of the 60-day payoff period to the shortest period that procedures will allow.
4. Payoff function should be automated as it will not only increase efficiency and time, but also lower labor costs in this process.
5. Procedures should also address access to failed bank liability/deposit structure prior to the bank being declared insolvent and closed for business. Early access will allow the DIA team to begin the preparation phase for a payoff, such as the capture of the deposit data, appropriate spreads, etc.
6. It is also recommended that in conjunction with the development of payoff procedures, the staff receives realistic training by conducting a simulated bank failure, using dated bank data and conducting a test payoff.
7. If USAID decides to provide technical assistance to the DIA in this area, the following are recommendations for the necessary skill-set of the TA provider.
    a. Experience in the pay-off function in the real/live environment
    b. Knowledge and experience in pay-out procedures
    c. Experience and training in the automated function of the payout procedure
    d. The time required for this TA, including development of payout procedures and payout simulation should be three weeks.

Benchmarks

Development of procedures	End of third quarter 2003
Training of staff including simulated failure	End of fourth quarter 2003
Shortening the deadline for completing the payoff function	End of second quarter 2004

II. Findings – Focus on Bank Monitoring and Analysis Relationship with the Entity Banking Agencies

1. This Agency considers off-site bank monitoring/analysis to be their primary function. Seven out of eleven technical staff personnel devote full or part time to performing this function. Although this situation creates a duplication of effort with the entity banking agencies' off-site department, which, as a regulator, has a full on-site capacity and the power to impose corrective measures, the current Law on Deposit Insurance requires the DIA to conduct off-site monitoring of banks.
2. The DIA, especially the Banja Luka branch, relies heavily on the banking agency information. The Banja Luka branch, as opposed to Sarajevo branch, does not have a direct access to the commercial banks data so it depends on the good will of the regulator to acquire bank data. Despite the significant reliance, the relationship between the DIA and the entity banking agencies is not at the most effective and efficient level. All individuals involved in the analysis/monitoring function were interviewed and all indicated the relationship itself was satisfactory, yet each described the difficulty in obtaining all necessary data and reports. Information between the Agencies is not routinely shared, which means the on site and other non-frequent examinations must be requested in writing.
3. The DIA analysts have so far performed their duties in a prudent and diligent manner. If the DIA is to continue performing this function satisfactory in the future, in lieu of increasing complexity in the banking sector, its analysts will need additional training. When compared to their colleagues at the banking agencies, the DIA analysts definitely lack additional training time. Sarajevo branch analysts attended only four seminars, while the Banja Luka branch analysts attended two trainings.

Recommendations

1. In order to improve the relationship and information sharing, a formalized agreement between the Deposit Insurance Agency and the entity banking agencies should be developed. This agreement should provide for routine information sharing. As a member bank deteriorates, it is of the utmost importance that DIA be aware of potential need and affect on the insurance fund. The agreement should also specify for joint training of the key technical staff in the agencies **(Please refer to Part Three for further details)**. In addition to maintenance of the off-site skill level, the DIA analysts need the following additional training to able to comprehend the on-site banking agency examination reports and fully understand the deteriorating bank's condition;
    a. Training in Regulatory Powers
    b. Focus Bank Examination and CAMEL Ratings
    c. The advisor should be able to identify further training needs as the banking industry becomes more complex
2. Establishment of the automated system, i.e. shared database for bank data, may alleviate part of the information-sharing problem. An automated system should,

therefore, be established so that all stakeholders (DIA, BAs, CBBH, and the entity Ministries of Finance) have access to bank data.

III. Findings – Management Authority

Management of this agency is operating with virtually no authority. The only delegation granted by the DIA statute is the hiring and firing of all employees below the branch director level. However, in practice, even that seems to be restricted. In essence, the Director has responsibility without appropriate authority.

Recommendation

The DIA Management Board must delegate additional authority to the Director. The Director should also perform the Human Resource Officer position that is currently not within the Organizational Structure. If the DIA Director is to fulfill this position, the following are the specific areas the Director must have authority.

1. Authority to reassign personnel – This will allow a more efficient utilization of human resources
2. Authority to upgrade the skill level needed for key positions
3. Authority to call upon other Agencies', such as the entity banking agencies, personnel when critical situations develop – The DIA Management Board should allow for a clause on this authority in the agreement with the entity banking agencies

The Director should also have greater expenditure authority. If the Management Board wishes to retain some of its powers in this area, written procedures should be in place so the internal auditor can determine whether the Director complies with the delegated authority. Therefore, the internal auditor, rather then the Management Board, should monitor the expenditure authority.

IV. Findings – Internal Control

The internal control position is open and unfilled. The need to fill this position is enhanced by weakness in the basic internal control problems surrounding the accounting function. The officer for financial operations (Suad Hukara) has complete control over virtually all financial transactions including all ingoing and outgoing activity, cash, reporting, and the budget process. The only oversight provided is the annual audit by Deloitte & Touché. The limited staffing restriction has contributed to this situation.

Recommendation

The internal control position must be filled immediately. Management has stated they intend to fill this position during the second half of this year. The internal control position person will require the following skills:

a. Financial/accounting background
b. Training/experience in risk-based internal audit techniques

The internal control position should conduct the following general functions.

a. Audit of the Financial Control Operations
b. Control and audit the compliance with liquidation procedures
c. Control and audit of all financial transaction pertinent to the Deposit Insurance Fund
d. Update, track, and determine the market and default risk of the Deposit Insurance fund (must be able to develop a financial model to track the market and default risk of the DIA similar to Mr. Peter Hand's financial model from November 2002).

Benchmarks

Internal control position filled:	Second Quarter 2003
Training in Financial Modeling	Third Quarter 2003

V. Findings – IT Function

The IT function is weak. The primary duties of the incumbent IT manager have been the maintenance of hardware and software within the agency. No significant development of IT software has taken place.

Recommendations

1. Enhancement of this position and function is imperative to future development as an efficient organization. Automation needs will be considerable as this organization grows to serve the needs of the banking industry and the country of BiH.

2. The priority should be given to the establishment of an IT system that links the organization in its entirety via server to include a management information system.

3. As previously stated, the payoff function should be given the highest priority and be automated to the fullest extent.

4. Although it is recognized that a significant amount of the development of an IT system will be outsourced, the individual IT coordinator should possess the appropriate skills to monitor and supervise the development of these systems.

Benchmarks

Development of an IT system to link the organization and provide a management information system.	Third Quarter 2003
Payoff system development includes automation	Fourth Quarter 2003

VI. Findings – Staff Utilization

At this time the limited staff of this agency (14) has 7 technical staff and managers dedicated to the analysis/monitoring function. This is in many respects a duplication of efforts with the entity banking agencies. While it is recognized that the function is important to protect the interest of the agency and provide adequate warning, it is anticipated that the number of institutions will decline to around 25 in the foreseeable future. Therefore, in view of the fact that other areas of the Agency are in need of attention, duplication of efforts with the banking agencies should be avoided.

Recommendations

The external advisor must, in accordance with the DIA Director, conduct a staff rationalization plan so to ensure the limited human resources are utilized to the maximum. Nonetheless, this plan must bear in mind the current needs of the Agency. As recommended above, the Agency needs to immediately address the following positions;

a. The Payout function lead officer
b. The IT Coordinator
c. The Internal Auditor
d. Liquidation department lead officer

Moreover, the current situation can improve, specifically after the period for membership expires. Following that time period, the DIA will devote fewer resources to the analysis/monitoring function, and the plan needs to carefully consider this situation.

Benchmarks

Evaluation of human resource utilization.	Third Quarter 2003
Identification of key positions within existing staff	Third Quarter 2003

USAID Advisor Skill Set Recommendation

If USAID decides to engage a full-time resident advisor to the DIA, the following skill set would be very beneficial to the DIA.

1. Deposit insurance background is essential. Experience with European deposit insurance programs is beneficial.
2. Experience in bank liquidation is essential.
3. Experience in conducting payout process is beneficial but not critical.

This advisor would be in charge of the following tasks:

1. All pertinent procedures development with the Director
2. Development of Director's and Branch Directors' management skills
3. Identification of key technical personnel training needs
4. Identification of trainings and seminars available – The coordination, regarding training needs, with the Advisor at the banking agencies must on a regular basis
5. Competency to address specific internal DIA training needs

VII. Findings – Problem Bank Resolution Function

1. By law, the problem bank resolution process is the responsibility of the entity banking agencies. The largest claimant on the liabilities of a problem bank, the DIA, is not represented during the liquidation function.
2. There is little or no incentive for the agencies (through the contract personnel) to timely conclude either the PA or liquidation function.
3. Internal controls are scarce. One example, the liquidator is responsible for not only arranging the sale of a bank asset, but also for the collection of the proceeds of the sale.

Recommendations:

1. A revision of the legal framework for problem bank resolution to transfer this responsibility from the banking agencies (prior to their integration with the CBBH) to the DIA. The revision should have the following characteristics modeled on the FDIC.

The model provided by the FDIC where a bank failure is as follows:

- FDIC appointed receiver
- All resolution matters and liquidation matters are the responsibilities of the FDIC
- FDIC Receiver reports to appropriate state court at the conclusion of the receivership affair

2. The resolution of problem banks should not be contracted out to third parties.
3. Procedures should be developed implementing internal controls in the resolution process.

MATRIX OF "HOW TO" STEPS FOR THE DIA AS TO RESOLUTION AND RECEIVERSHIP

TOPIC	**START-COMPLETE**	**T.A. REQUIRED**	**COMMENTS**
Initial discussions with all interested parties as to moving of problem bank resolution function to DIA.	March-March, 2003	USAID contractor and/or DIA advisors to coordinate these discussions.	Discussions should be with the FBA, DIA, RSBA, CBBH and other interested parties including the DIA advisors.
Draft of checklist of legal changes needed.	April-May, 2003	USAID advisor with banking and deposit insurance legal skills.	To include both resolution issues and receivership powers
Establishment of transitional team.	June-June, 2003	USAID and/or DIA advisors to advise team.	Team would include appropriate persons at the RSBA, FBA and DIA and the CBBH.
Drafting of legal changes needed to achieve the transfer of the bank resolution function & ensure sufficient receivership powers	June-September, 2003	USAID legal advisor with legal skills in drafting financial sector legislation.	
Passing or amending all required changes to legal framework.	October, 2003-February, 2004	USAID advisor to oversee this process.	Political "handholding" should be expected to be performed by the Governor of CBBH.
"Change Manager" to assist in HR issues resulting from the organizational changes.	January-March, 2004	USAID advisor who is a HR specialist in such processes.	This process is similar those services provided to the FBA and RSBA the previous year.
Problem bank resolution.	April, 2003-March, 2004	USAID contractor to provide specialist with appropriate expertise.	This person will probably be needed for 10-12 man months.
Completion of the transfer of problem bank resolution function to the DIA	June, 2004	USAID advisor to coordinate the completion of the project.	

Annex One

List of Interviews Held

Peter Nicholl, Governor, CBBH
Dale Wilson, USAID Bank Supervision Advisor FBA
Greg Tabor, USAID Bank Supervision Advisor RSBA
Zlatko Bars, Director, FBA
Mustafa Brkic, Deputy Director, FBA
Sanja Custovic, Assistant Director, FBA
Spomenka Nikolic, Head of On-Site Supervision, FBA
Sanja Hussain, Head of Off-Site Supervision
Branko Ekert, Secretary, UPI Banka
Ljubica Tankosic, Executive Director of Branches, UPI Banka
Ognjen Samardzic, Executive Director, Raiffeisen Bank
Michael Muller, Member of the Management Board, Raiffeisen Bank
Ranko Travar, Chief Executive Officer, Razvojna Bank
Dusanka Novakovic, Acting Director, RSBA
Zeljka Rakocija, Director of Bank Supervision Sector, RSBA
Mile Tamamovic, Manager On-Site Supervision, RSBA
Nena Dragas, Manager for Off-Site Supervision, RSBA
Jela Radisic, Advisor for Accounting and Privatization, RSBA
Dragomir Drazic, Director of Legal and Licensing Sector, RSBA
Miodrag Beric, Director of Provisional Administration and Liquidation, RSBA
Zeljka Racocija, Head of Supervision, RSBA
Nena Dragas, Head of Off-site supervision,RSBA
Mile Tamamovic, Head of On-site supervision,RSBA
Miralem Babajic, Liquidation Department FBA
Robert Demler, US Treasury Advisor
Rainer Muller, GTZ Project Manager at DIA
Josip Nevjestic, Director, DIA
Sead Manov, Sarajevo Branch Director, DIA
Branislava Lisica, Banja Luka Branch Director, DIA
Branko Salatic, Head of Legal Operations, DIA
Suad Hukara, Head of Financial and Control Operations, DIA
Camila Salaka, Coordinator for Membership and Premium Insurance, DIA
Zijad Imamovic, Assistant for Bank Analysis and Monitoring, DIA
Nadja Tikvesa, Assistant for Bank Analysis and Monitoring, DIA
Gorana Krunic, Assistant for Bank Analysis and Monitoring, DIA
Mirela Canic, Assistant for Bank Analysis and Monitoring, DIA

Annex Two

List of Key Documents Reviewed (excludes many short memos and internal notes provided)

FSVC Project Descriptions for Operational and Financial Sustainability Consultations
Laws on Banks and Central Banking (both state and entity level)
Financial Sector Assessment, April 2002 (Barents)
IMF aide-memoire dated November 11, 2002 to Governor Nicholl
Information on the Banking System of FbiH as of September 30, 2002
Information on the Banking System of RS as of September 30, 2002
Implementation Assessment of Core Principles for RSBA
Implementation Assessment of Core Principles for FBA
Country Report, Economist October 2002
Development Strategy – Financial Sector BiH, completed by PRSP
Organizational Structure of Banking Supervision, Financial Stability Institute
BiH Banking Agency, Regulations on Designation of Duties
Governor's Discussion Paper on Banking Supervision to the CBBH Board, Oct. 2001
Selected Documents of FBA and RSBA, including:

- Examination Reports
- Off-site Analysis
- Follow-up orders
- 2002 and 2003 planning materials
- Organizational charts

Annex Three

SYNOPSIS OF THE MAIN MODELS FOR THE STRUCTURE OF BANKING SUPERVISION

As banking supervision has evolved in both developed and transition economies, the structure of how banks are supervised has differed. This annex gives three main models as to: a description; economies that use the particular model; and the positive and negative feature for each model.

Model One – the American system

The USA banking supervision model is highly complex and his evolved historically. While banking sector reforms have been periodic (including 1999 legislation to remove the barriers separating commercial banks and other financial sector products/activities), the banking supervision structure has changed little since the great depression of the 1930s.

The dual banking system in the USA allows banks to be chartered (licensed) either at the state or federal level. All state chartered banks are supervised by the state banking authorities, while federally chartered (national banks) are supervised by the Office of the Comptroller of the Currency. State chartered banks may choose whether or not to join the Federal Reserve System (such membership is required for nationally chartered banks). The Federal Reserve becomes the main supervisor for state-member banks. Virtually all American banks carry deposit insurance, and this leads to the FDIC being the primary federal supervisor for state chartered non-Fed member banks.

The system is made even more complex by the role of bank holding companies (all supervised by the Fed) and the FDIC supervisory role for all banks it insures, even if it not the primary supervisor as indicated above.

The result is a *multiplicity of jurisdictions* that, while working in large part for the American banking sector, is seen by consensus as a poor model for transition countries to emulate.

Model Two – the Central Bank as banking supervisor

Central banks have been the banking supervisor in a large number of countries, and there is a long historical tradition of this. The most common form is for the banking supervisors to be staff members reporting directly or indirectly to the Governor, who in turn is responsible to the Central Bank's board.

Examples at present of central bank supervision: Russia, China, Malaysia, Egypt, Philippines

Advantages to this model:

- Central banks tend to have significant independence from political interference
- Central banks can more easily fund or otherwise financially support banking supervision functions without imposing large fees on banks
- Central banks and their Governors tend to have more stature and respect as compared to separate agencies and they are seen as a part of the financial sector rather than a pure regulator of it - thus a more collegial atmosphere of supervision and regulation often exists
- Central banks are almost always the most well established entities in the banking sector - thus "institution building" is not usually a major concern
- Central banks often have additional prominence in smaller or less developed financial sectors, thus they are often seen as a natural home for banking supervision
- Supervision inside the central bank allows for close coordination with monetary policy and/or lender of last resort functions (these have yet to evolve in the CBBH but will once it becomes a full central bank)

Disadvantages to this model:

- Central banks should *not* normally engage in certain aspects of financial sector supervision which fall outside their traditional role, including:

1. They should not be the deposit insurer nor should they liquidate banks
2. They should not be the supervisory authority for the non-banking segments of the financial sector, i.e. securities and insurance

While the above disadvantages should be recognized, they can be overcome via coordination with other financial sector supervisors and with the deposit insurance agency

<u>Model three – the Unified Financial Sector Supervisor</u>

A unified financial sector supervisory agency is based on the premise that all components of the financial sector should be supervised by the same agency. This was the thinking in 1997 behind the UK government moving banking supervision out of the Bank of England and into the new Financial Supervision Agency (FSA). The FSA now supervises the UK's entire complex financial sector. Several other economies, mainly large and well-developed ones with sophisticated financial sectors, have since shifted to this model.

Examples at present of unified financial sector supervision: United Kingdom, Japan, Australia, Korea

Advantages to this model:

- It is well suited for supervision of complex financial conglomerates who have activities in multiple financial sector areas, i.e. a bank that offers insurance and underwrites securities
- It is intended for well developed financial sectors where commercial banking is but one element of the sector but far from the predominant activity

Disadvantages to this model:

- Creating a new unified financial sector supervisor (unified agency) involves complex and time consuming "institution building" with many vested interests needing to come together
- Unified agencies only have a skeletal balance sheet, thus usually imposing heavy fees on banks to support themselves and having no funds to assist banks, such as a lender-of-last-resort function
- As an agency, it is seen by the sector as a pure regulator rather than part of the financial sector itself (as central banks are seen)
- As an agency of government (unlike a central bank), they are more prone to political interference from Ministries etc.

NOTE: Several of the above points would apply to <u>any form of agency level supervision</u> (as exists now in BiH with two entity agencies) not just a unified financial sector supervisory agency.

<u>Summary and recommendation</u>

The complex American model is not at all suited for BiH. Thus the choice is between banking supervision within the central bank or an agency option (the latter presumes a newly combined state-level agency that may well include other areas of supervision such as insurance and securities).

The recommendation is for the central bank model as being better suited for the banking sector of BiH given its present level of development and foreseeable development. The CBBH Governor supports this view, and the advantages and disadvantages for the models given above make this choice rather clear. The main reasons for this are listed as follows:

1. Banking is by far the predominant activity in the BiH financial sector, and this is unlikely to change soon
2. The CBBH here is well established and well respected; this removes difficult and very time consuming *institution building*
3. Placing banking supervision inside the CBBH will shield the function from outside political interference from Ministries etc. (this point was emphasized by the CBBH Governor)

4. The CBBH has a strong funding base and thus would make banking supervision financially sustainable and enable most or all of the presently onerous fees on banks to be removed
5. In due course, the CBBH is likely to become a full central bank and the linkage between banking supervision and lender-of-last resort would be fully coordinated (this is a problem in developing or transition countries where supervision is outside the central bank)
6. The issues of coordination with deposit insurance and other very small financial sector supervisors can be covered smoothly via an Advisory Committee of interested parties as well as periodic coordination as to common interests

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