NATIONAL BANK OF SERBIA

STRATEGY FOR IMPLEMENTATION OF BASEL III STANDARDS IN SERBIA

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I BANKING SECTOR IN SERBIA – STATE AND TRENDS

The primary objective of the NBS is to achieve and maintain price stability. Without prejudice to its primary objective, the NBS also contributes to the maintaining and strengthening of financial stability. One of the NBS's instruments for accomplishing this goal is the function of the regulator and supervisor of the major part of the Serbian financial sector, including banks.

Banking sector is the most significant part of the Serbian financial system. Worth RSD 2.905 billion at the end of September 2013, it accounts for over 90% of total (net) assets in the financial system. Consolidation of our banking sector is an ongoing process. At the close of 2013 there are 30 banks operating in Serbia, five fewer than at the end of 2007, before the adoption of the Strategy for the introduction of Basel II standards. Two key events marked the period between the Strategy for the introduction of Basel II standards and the Strategy for implementation of Basel III standards:

- Implementation of Basel II standards was successful - the capital adequacy ratio of banks in Serbia is calculated in accordance with Pillar 1 of Basel II standard since the end 2011, whereas the effects of the transition from Basel I to Basel II were adequately assessed in advance; Internal Capital Adequacy Assessment Process in accordance with Pillar 2 inextricably linked business strategy of banks, risk management strategy and capital management strategy – capital must now reflect the overall risk profile of a bank, which is the result of its operations and business decisions; disclosure of data and information by banks under Pillar 3 significantly improved the transparency of banks' business and thereby strengthened market discipline in the banking sector.
- The global financial crisis that erupted in 2007 and escalated in 2008 and whose tremors are still felt around the world, did not by pass Serbia and its effects have left a mark on its banking sector: the volume of NPLs has increased, lending activity has slowed and the deleveraging process has begun. In order to preserve the stability of the banking sector, the National Bank of Serbia adopted several rounds of counter-cyclical regulatory measures, whose effective implementation was made possible by the fact that considerable reserves were accumulated during the pre-crisis period. It is these reserves, accumulated as a result of a conservative approach to regulation and supervision of banks that were an adequate absorber of the losses caused by the current crisis, and still represent a key guarantor of the resilience of the banking sector to any potential shocks. The full effect of regulatory measures aimed at reducing the level of NPLs is expected over the years to come. Until such time when those effects become fully manifest, the NPLs remain fully covered by the regulatory provisions and the capital adequacy continues to run high at 20%. With the growth of gross domestic product and the recovery of the real sector, we expect to see a decline in the level of non-performing loans and a rise in lending activity, as factors on the supply side (high liquidity and capitalization of

banks) allow for it. Banks are slowly changing their business models and are turning to local sources of finance, thereby preventing rapid, disorderly deleveraging. The stability of the banking sector has ensured the preservation of the overall financial stability.

II NEW STANDARDS OF THE BASEL COMMITTEE ON BANKING SUPERVISION

After the outbreak of the global financial crisis, weaknesses of the financial systems worldwide, as well as deficiencies of the generally accepted standards and regulations were exposed. The process of change of Basel standards and regulations was initiated at the international level.

In this sense, initial steps were taken in July 2009 when the first set of documents was published - *Enhancements to the Basel II framework*, *Revisions to the Basel II market risk framework* and *Guidelines for computing capital for incremental risk in the trading book*. These changes of the Basel II standards, which are primarily related to market risk and securitization, are referred to as Basel 2.5 standards. However, crucial and comprehensive changes of Basel standards - Basel III, were provided in a set of documents published in December 2010 and introduced changes primarily to the rules regarding capital adequacy ratio, and in particular, to the regulatory capital (the numerator of the indicator). Also, for the first time, minimum standards relating to the required level of liquidity were introduced. Set of documents published in December 2010 consists of draft comprehensive text of the amended document from 2006 - *A global regulatory framework for more resilient banks and banking systems*, as well as *International framework for liquidity risk measurement, standards and monitoring*, which is related to the new standards in the area of liquidity. In June 2011 a revised document relating to the Basel III standards, was published - *A global regulatory framework for more resilient banks and banking systems – revised version*.

The most important novelties introduced by Basel III standards are:

1. new capital standards:
   - improvement of the quality of capital and strengthening capital requirements;
   - establishment of three minimum capital standards;
   - improvement of the risk management process to ensure proper coverage of all risks with capital;
   - introduction of a series of measures in order to establish adequate capital reserves (capital buffers) that would be available in times of crisis;
   - introduction of a leverage ratio as an additional indicator which is not based on the level of assets' riskiness;
   - introduction of additional capital requirements for systemically important banks;

2. introduction of minimum standards for liquidity risk management, as well as minimum liquidity ratios.

III IMPLEMENTATION OF BASEL STANDARDS IN THE EUROPEAN UNION

Implementation of Basel II standards in the EU was finalized with the adoption and implementation of Directives 2006/48/EC and 2006/49/EC, known as the *Capital Requirements Directive* (hereinafter: CRD), which all Member States were required to transpose into national legislation by the end of 2006. Implementation of Basel II standard in the EU began on 1 January 2007.

The first wave of the financial crisis, which in the short period of time transcended national and financial sector boundaries, growing into the greatest economic crisis of modern times, emphasized the fact that the existing international regulatory framework for banks left too much room for uneven national implementation and for regulatory arbitrage.

Along with the changes to Basel II standards (Basel 2.5 standards), work on changing EU regulatory framework began by amending existing, or adopting new directives by the European Commission. EU regulators are required to monitor and adjust their national frameworks in accordance with new directives concerning capital requirements for banks.

The first significant change of the CRD was in 2009 when, ending with September 2009, a new set of directives was adopted: Directives 2009/27/EC, 2009/83/EC and 2009/111/EC, commonly referred to as CRD 2. These directives, whose national implementation in the EU was conducted by the end of 2010, primarily regulate the inclusion of hybrid instruments in Tier 1 capital, large exposures and cooperation between home and host supervisors of banking groups. After that, the Directive 2010/76/EC (the CRD 3) was adopted with the aim of further regulating the implementation of the rules relating to securitization, capital requirements for market risk and remuneration policies, and whose national implementation in the EU member states started by end of 2011. Directives CRD 2 and CRD 3 implemented Basel 2.5 standards in the European Union.

At the beginning of the financial crisis, CEBS 's (now EBA)1 technical advice was that about 20 % of the analyzed Member States' discretions be kept in the directives, while the option of Member States to apply different treatments depending on the local conditions should be abolished (the remaining 80 % of discretion rights).

Relying on CEBS' technical advice on national options and discretions, the European Commission has prepared a draft of changed directives, and also proposal of a new regulation with the goal of eliminating all undesired national options and discretions, and with those novelties the latest changes of the Basel

[1] *The European Banking Authority* (EBA) started working on 1 January 2011 and took over all the activities previously done by CEBS – *Committee of European Banking Supervisors*

standards - Basel III standards were implemented in EU. On 20 July 2011 the European Commission announced proposals for the Capital Requirements Regulation and the Capital Requirements Directive[2] 4 - CRR and CRD 4, which made a significant step towards achieving a goal of establishing the so-called *"Single rule book"* - maximum harmonization of regulation at the EU level to limit the possibility of deviations from what is stipulated in the new regulatory framework. Although their adoption was initially planned in 2012 and their application from 1 January 2013, the final versions of the CRR and the CRD 4 were adopted and published in the Official Journal of the EU in June 2013 and they will be applied as of 1 January 2014.

It is important to note that, given the goal of establishing uniform rules for all banks in the EU, the new EU regulatory framework based on the Basel III standards (unlike the current based on the Basel II), does not allow supervisors to establish more conservative standards at the national level, except in a small number of clearly prescribed cases. Instead, it envisages that stricter rules can only be applied at the level of individual banks, through the application of Pillar 2 of Basel standards.[3]

IV REGULATORY FRAMEWORK IN SERBIA AND BASEL STANDARDS

Implementation of Basel II in Serbia was finalized with the adoption of the package of regulation by the Executive Board of the National Bank of Serbia in June 2011. The above package, which harmonizes rules for calculating capital adequacy and risk management process with Basel II standards, and enhances transparency in banking operations, consists of six decisions published in the "RS Official Gazette" Nos. 45/2011 and 46/2011: Decision on Capital Adequacy of Banks, Decision on Reporting on Capital Adequacy, Decision on Risk Management by Banks, Decision on Disclosure of Data and Information by Banks, Decision on Consolidated Supervision of a Banking Group, Decision on Bank Reporting Requirements. This set of regulations is applied from 31 December 2011, with the exception of provisions relating to the recognition of eligibility of credit ratings assigned by rating agencies, which are applied from 1 September 2011, as well as certain provisions for which a transitional period for full implementation is prescribed.

However, in the domestic regulatory framework for banks, which came into force on 31 December 2011, there are some differences in relation to Basel II standards. Whereas, for example, the Basel standards prescribe specific rules for calculating the capital requirement for credit risk which arises from securitization,

[2] EU regulation in contrary to EU directives is not transposed into national legislation (laws), but is directly (by translation into the language of the Member State) applied in national legislation.

[3] An example of a shift from minimum standards to maximum regulatory harmonization is the prescribed minimum capital adequacy ratio at the international level, which remains 8%, but there is no possibility for national supervisors to prescribe higher indicator when it is assessed that the conditions at the national level require that (as was the case with Basel II standards).

this capital requirement is not covered by the Decision on Capital Adequacy of Banks, due to the lack of a legal framework in Serbia for securitization and underdeveloped practices of banks in this area.

Since Basel 2.5 standards are mainly related to the improvement of Basel II standards in the area of market risk, securitization and remuneration policies, they are not yet implemented in Serbia, due to the lack of a legal framework and practice in the area of securitization as well as because of the relatively low importance of market risk in the Serbian banking sector[4], while in the area of remuneration policies they are partially implemented. Accordingly, and taking into account local specificities, the implementation of Basel 2.5 standards in Serbia will be conducted in accordance with this strategy, together with the implementation of Basel III standards.

On the other hand, bearing in mind that the implementation of Basel II standards in Serbia was conducted at a time when Basel III standards were already published by the Basel Committee on Banking Supervision, some elements of Basel III standards have already been introduced in Serbia by the Decision on Capital Adequacy of Banks, as follows:

- Tier 3 capital items and instruments are excluded from the definition of regulatory capital (usage of Tier 3 capital was possible in accordance with regulation in force until 31.12.2011), which contributed to strengthening the quality of capital, that now includes only core (Tier 1) and supplementary capital (Tier 2);
- Limitations on the distribution of profit are prescribed in order to create additional capital reserves (*capital conservation buffer*): banks whose capital adequacy ratio is higher or, because of the distribution of income, would be higher than prescribed (12%) by less than 2.5 percentage points, can allocate their income only to the elements of the common equity.

V MAIN GOALS AND PHASES OF THE IMPLEMENTATION OF BASEL III STANDARDS

Given the goal of preserving the stability of the banking sector and financial system as a whole, as well as the strategic orientation of the NBS to continuously improve the regulatory framework in line with international standards and EU regulation and taking into consideration the specificities of domestic legal framework and market, the NBS will in line with this strategy take all necessary activities and adopt appropriate regulation that will enable the implementation of Basel III standards in Serbia.

Bearing in mind that this is a complex and multi-disciplinary process, the implementation of Basel III standards will be conducted in three phases:

1. **Preparatory phase - the first quarter of 2014**

[4] Currently in the banking sector of Serbia, only 2% of total capital requirements is related to the capital requirements for market risk.

In the preparatory phase, there are three main activities to be carried out before proceeding to the next phase:

- conducting analysis of (non)compliance (gap analysis) between Basel 2.5 and Basel III standards on the one hand, and the existing regulatory framework for banks in Serbia, on the other;
- conducting a comparative analysis of the dynamics of the introduction and implementation of Basel III standards by Member States of the European Union and neighboring countries;
- setting out the Operational Plan for Implementation of Basel III standards (hereinafter: Operational Plan), which will precisely define organizational aspects of the implementation process, as well as actions and deadlines for the implementation of the second and third phases of the Strategy.

2. **Effects assessment and determination of the dynamics for implementation phase - until the end of 2014**

Implementation of Basel III standards introduces significant and numerous novelties, in terms of both capital adequacy and the liquidity ratio, and is a gradual process at the international level. The Basel Committee on Banking Supervision has prescribed that the gradual implementation of Basel III standards be conducted from 2013 to 2019, while in the EU, after the initial delay in the adoption of the regulations a phased implementation will begin in 2014.

Under the current regulatory framework, the Serbian banking sector is adequately capitalized and highly liquid. Before changing regulation, it is necessary to assess the effects of these changes. Therefore, the main activity in this phase will be the development of quantitative impact studies of the new standards on capital adequacy and liquidity across the banking sector and individual banks. Accordingly, quantitative impact studies will be conducted in direct cooperation with all banks and the Association of Serbian Banks.

The results of these analyses will serve as a basis for determining the pace of implementation of all elements of the Basel III standards, while at the same time bearing in mind the planned schedule for implementation of certain elements thereof in the EU.

3. **Legislation drafting phase - until the end of 2015**

Upon completion of the preparatory phase and effects assessment and determination of the dynamics for implementation phase, development of regulation that will implement Basel 2.5 and Basel III standards in Serbia will commence. During the implementation of this phase, as in the case of the previous one, the Association of Serbian Banks and individual banks will be actively involved. In addition, professional community will be involved in this phase in an adequate manner, as this phase envisages a public debate of all draft regulations.

Bearing in mind the importance and complexity of the process of implementation of Basel III standards, the Strategy will, when necessary, be amended and/or supplemented, taking into account new circumstances and challenges as they emerge.

The process of introducing Basel III standards will be based on the principle of transparency. In this sense, the strategy, as well as its potential changes, will be published on the website of the NBS and will be accessible to all interested parties.