Document of

**The World Bank**

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Report No: PAD2334

INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

PROJECT APPRAISAL DOCUMENT

ON A

PROPOSED LOAN

IN THE AMOUNT OF EUR 40.1 MILLION (US$50 MILLION EQUIVALENT)

TO THE

REPUBLIC OF SERBIA

FOR A

STATE-OWNED FINANCIAL INSTITUTIONS STRENGTHENING PROJECT

FEBRUARY 27, 2018

Finance, Competitiveness and Innovation Global Practice
Europe And Central Asia Region

CURRENCY EQUIVALENTS

Exchange Rate Effective: January 31, 2018

| | |
|---|---|
| Currency Unit = | RSD |
| RSD 95.43 = | US$1 |
| EUR 0.802 = | US$1 |

FISCAL YEAR
January 1 – December 31

| | |
|---|---|
| Regional Vice President: | Cyril Muller |
| Country Director: | Linda Van Gelder |
| Senior Global Practice Director: | Ceyla Pazarbasioglu-Dutz |
| Practice Manager: | Mario Guadamillas |
| Task Team Leader(s): | Gunhild Berg |

## ABBREVIATIONS AND ACRONYMS

| | |
|---|---|
| AOFI | Serbian Export Credit and Insurance Agency |
| AQR | Asset Quality Review |
| ATM | Automated Teller Machine |
| BoD | Board of Directors |
| BP | Bank Procedures |
| BPS | Banka Postanska Stedionica |
| CAR | Capital Adequacy Ratio |
| CEO | Chief Executive Officer |
| CFO | Chief Financial Officer |
| CFU | Central Fiduciary Unit |
| CMO | Chief Market Officer |
| COO | Chief Operating Officer |
| CPF | Country Partnership Framework |
| CQS | Consultant Qualification Selection |
| CRO | Chief Risk Officer |
| DA | Designated Account |
| DF | Development Fund |
| DIA | Deposit Insurance Agency |
| DLI/R | Disbursement Linked Indicators/Results |
| DPLs | Development Policy Loans |
| EIB | European Investment Bank |
| EBRD | European Bank for Reconstruction and Development |
| EC | European Commission |
| ECA | Europe and Central Asia |
| EEPs | Eligible Expenditure Programs |
| EOI | Expression of Interest |
| EU | European Union |
| EUR | European Euro |
| FCI | Finance, Competitiveness, and Innovation |
| FBS | Fixed Budget Selection |
| FM | Financial Management |
| GDP | Gross Domestic Product |
| GRS | Grievance Redress Service |
| HR | Human Resources |
| IAS | International Accounting Standards |
| IBRD | International Bank for Reconstruction and Development |
| IDA | International Development Association |
| IFC | International Finance Corporation |
| IFIs | International Financial Institutions |
| IFRs | Interim Unaudited Financial Reports |
| IMF | International Monetary Fund |
| IPF | Investment Project Financing |
| IPSAS | International Public Sector Accounting Standards |
| ISA | International Standards on Auditing |
| IT | Information Technology |
| KfW | Kreditanstalt für Wiederaufbau |
| KPIs | Key Performance Indicators |
| LCS | Least-Cost Selection |
| M&E | Monitoring and Evaluation |
| MoE | Ministry of Economy |
| MoF | Ministry of Finance |
| MoFFS | Ministry of Finance unit on Financial Sector |
| NBFIs | Non-Banking Financial Institutions |
| NBS | National Bank of Serbia |
| NPLs | Non-Performing Loans |
| OECD | Organization for Economic Co-operation and Development |
| P&A | Purchase and Assumption |
| PDO | Project Development Objective |
| PEFA | Public Expenditures and Financial Accountability |
| PIU | Project Implementation Unit |
| POM | Project Operational Manual |
| PPS | Public Policy Secretariat |
| PTT | Serbian Post, Telegraph and Telecommunications Company |
| QBS | Quality-Based Selection |
| QCBS | Quality-and Cost-Based Selection |
| REOI | Request for Expression of Interest |
| RMD | Risk Management Department |
| RoS | Republic of Serbia |
| RSD | Serbian Dinar |
| SBA | Stand-By Arrangement |
| SCD | Systematic Country Diagnostic |
| SME | Small- and Medium-sized Enterprise |
| SOE | State-Owned Enterprise |
| SPDs | Standard Procurement Documents |
| STA | Single Treasury Account |
| STEP | Systematic Tracking of Exchanges in Procurement |
| TA | Technical Assistance |
| USAID | United States Agency for International Development |
| USD | United States Dollar |
| WB | World Bank |

## BASIC INFORMATION

| Is this a regionally tagged project? | Country(ies) | Financing Instrument |
|---|---|---|
| No | | Investment Project Financing |

[ ] Situations of Urgent Need of Assistance or Capacity Constraints

[ ] Financial Intermediaries

[ ] Series of Projects

| Approval Date | Closing Date | Environmental Assessment Category |
|---|---|---|
| 20-Mar-2018 | 01-Aug-2022 | C - Not Required |

| Bank/IFC Collaboration |
|---|
| No |

### Proposed Development Objective(s)

The Project Development Objective is to improve the performance of Banka Postanska Stedionica AD Beograd and promote the reform of Development Finance Institutions and Other State-Owned Financial Institutions.

### Components

| Component Name | Cost (US$, millions) |
|---|---|
| Support the Reform of State Owned Financial Institutions | 34.87 |
| Strengthen Institutional Capacity | 15.00 |

### Organizations

| | |
|---|---|
| Borrower : | Republic of Serbia |
| Implementing Agency : | Ministry of Finance |

## PROJECT FINANCING DATA (US$, Millions)

| [ ✓ ] Counterpart Funding | [ ✓ ] IBRD | [ ] IDA Credit | [ ] IDA Grant | [ ] Trust Funds | [ ] Parallel Financing |
|---|---|---|---|---|---|

| Total Project Cost: | Total Financing: | Financing Gap: |
|---|---|---|
| 56.00 | 56.00 | 0.00 |
| | Of Which Bank Financing (IBRD/IDA): | |
| | 50.00 | |

**Financing (in US$, millions)**

| Financing Source | Amount |
|---|---|
| International Bank for Reconstruction and Development | 50.00 |
| Borrowing Country's Fin. Intermediary/ies | 6.00 |
| **Total** | **56.00** |

**Expected Disbursements (in US$, millions)**

| Fiscal Year | 2018 | 2019 | 2020 | 2021 | 2022 |
|---|---|---|---|---|---|
| Annual | 0.00 | 7.25 | 14.26 | 13.17 | 15.33 |
| Cumulative | 0.00 | 7.25 | 21.51 | 34.68 | 50.00 |

## INSTITUTIONAL DATA

**Practice Area (Lead)**

Finance, Competitiveness and Innovation

**Contributing Practice Areas**

### Climate Change and Disaster Screening

This operation has been screened for short and long-term climate change and disaster risks

### Gender Tag

Does the project plan to undertake any of the following?

a. Analysis to identify Project-relevant gaps between males and females, especially in light of country gaps identified through SCD and CPF

No

b. Specific action(s) to address the gender gaps identified in (a) and/or to improve women or men's empowerment

No

c. Include Indicators in results framework to monitor outcomes from actions identified in (b)

No

## SYSTEMATIC OPERATIONS RISK-RATING TOOL (SORT)

| Risk Category | Rating |
|---|---|
| 1. Political and Governance | Substantial |
| 2. Macroeconomic | Moderate |
| 3. Sector Strategies and Policies | Moderate |
| 4. Technical Design of Project or Program | High |
| 5. Institutional Capacity for Implementation and Sustainability | Substantial |
| 6. Fiduciary | Substantial |
| 7. Environment and Social | Moderate |
| 8. Stakeholders | Substantial |
| 9. Other | |
| 10. Overall | Substantial |

## COMPLIANCE

### Policy

Does the project depart from the CPF in content or in other significant respects?

[ ] Yes [✔] No

Does the project require any waivers of Bank policies?
[ ] Yes [✓] No

| Safeguard Policies Triggered by the Project | Yes | No |
|---|---|---|
| Environmental Assessment OP/BP 4.01 | | ✓ |
| Natural Habitats OP/BP 4.04 | | ✓ |
| Forests OP/BP 4.36 | | ✓ |
| Pest Management OP 4.09 | | ✓ |
| Physical Cultural Resources OP/BP 4.11 | | ✓ |
| Indigenous Peoples OP/BP 4.10 | | ✓ |
| Involuntary Resettlement OP/BP 4.12 | | ✓ |
| Safety of Dams OP/BP 4.37 | | ✓ |
| Projects on International Waterways OP/BP 7.50 | | ✓ |
| Projects in Disputed Areas OP/BP 7.60 | | ✓ |

### Legal Covenants

### Conditions

## PROJECT TEAM

Bank Staff

| Name | Role | Specialization | Unit |
|---|---|---|---|
| Gunhild Berg | Team Leader(ADM Responsible) | | GFCEW |
| Benedicta T. Oliveros | Procurement Specialist(ADM Responsible) | | GGOPC |
| Aleksandar Crnomarkovic | Financial Management Specialist | | GGOEW |
| Amir Munir | Team Member | IT specialist | ITSCR |

| | | | |
|---|---|---|---|
| Andrew Lovegrove | Team Member | State Owned Bank reform | GFCLC |
| Fabiola Altimari Montiel | Counsel | | LEGLE |
| Igor Matijevic | Team Member | NPL resolution | GFCE2 |
| Ingrid Jaklitsch | Team Member | | GFCEW |
| Jelena Lukic | Social Safeguards Specialist | | GSUGL |
| Joseph Huntington La Cascia | Team Member | IT procurement | GGOPC |
| Luis M. Schwarz | Team Member | | WFACS |
| Matija Laco | Team Member | Development Finance | ECCEU |
| Natalie Nicolaou | Team Member | | GFCEE |
| Nikola Ille | Environmental Safeguards Specialist | | GEN03 |

**Extended Team**

| Name | Title | Organization | Location |
|---|---|---|---|

**SERBIA**
State-Owned Financial Institutions Strengthening Project

**TABLE OF CONTENTS**

# I. STRATEGIC CONTEXT

## A. Country Context

1. **The global financial crisis that began in 2008 exposed weaknesses in the Serbian economy prompting a need to rethink the overall growth model for the country.** The Serbian economy grew rapidly averaging 5.0 percent growth for 2001-2009 prior to the onset of the global financial crisis, fueled by domestic consumption and funded by significant capital inflows. This led to substantial external imbalances, with the current account deficit reaching over 20 percent of gross domestic product (GDP) in 2008. This demand-driven growth model was proven unsustainable in 2009, when real GDP fell by 3.1 percent, unemployment increased by 2.5 percent and total investment decreased to 20 percent of GDP from 25 percent in 2008. The crisis exposed the need to accelerate the incomplete transition to a market-based economy and address obstacles to development, including the significant role of the state in the economy and an unfavorable business environment.

2. **Following lackluster performance since the crisis, Serbia's economic growth is expected to pick up in the context of fiscal consolidation and an ambitious structural reform program**. In 2014, the economy fell into recession for the third time in six years, partially due to the devastating floods in May 2014. Real GDP recovered in 2015 with modest growth of 0.8 percent and stronger growth of 2.8 percent in 2016. Unemployment fell to 15.3 percent in 2016, after reaching a peak of 24 percent in 2012, reflecting the recent recovery in economic activity. Real GDP growth is projected to reach 4 percent by 2020, underpinned by a more supportive external demand, improved investment, and a gradual recovery of consumption. In late 2014, the government put in place an ambitious reform program[1] that focuses on fiscal consolidation to ensure macroeconomic stability, improving financial sector stability and resilience, boosting competitiveness and ensuring sustainable growth. The new government, formed in August 2016, is committed to these reforms, along with pursuing accession to the European Union (EU). The program is supported by a three-year International Monetary Fund (IMF) Stand-by Agreement (SBA).

3. **A key element of the government's reform program involves reducing the role of the state in the economy to boost competitiveness and decrease fiscal expenditures.** The transition to a market economy began in earnest in 2001. Significant gains were made in the early years of the transition, with over 2,700 enterprises privatized. However, the state continues to play a large role in the economy. There are about 800 state-owned enterprises (SOEs) that employ about 10 percent (200,000 workers) of the formal Serbian workforce. These enterprises include public utilities, numerous commercial enterprises, and several state-owned financial institutions (SOFIs) that play a significant role in the financial sector. Many of these enterprises perform poorly, have weak governance and oversight, and are prone to politically influenced decision making. The prevalent role of the state in the economy creates significant distortions and misallocation of resources. Since SOEs have a major role in nearly every sector of the economy, private investment is crowded out and valuable labor, capital, and land are not allocated productively. De facto wage policy in many SOEs, although in principle related to the public wage salary scale, is relatively liberal and further distorts the already high public/ private wage ratio.

4. **SOEs make significant losses, equal to about 3 percent of GDP or over EUR 1 billion.** To stay afloat, many public-sector enterprises receive significant direct budget subsidies, as well as indirect support

[1] Fiscal Strategy for 2016-2018.

in various forms, including unpaid taxes and contributions, state guarantees for loans, and accumulation of arrears to SOFIs, other state entities and public utilities. Across all categories of SOEs, yearly cash outflows and equivalents for both direct and indirect support is estimated to be about 3 percent of GDP annually. The accumulation of arrears to SOFIs and public utilities translates to direct losses for these enterprises.

## B. Sectoral and Institutional Context

5. **The Serbian financial sector is dominated by the banking sector with strong foreign bank presence.** The banking sector accounts for 91 percent of financial sector assets (see Table 1). At the end of the second quarter in 2017, there were 31 licensed banks in Serbia, including 21 foreign-owned banks, mainly from Europe, 6 state-owned banks[2] and 4 privately-owned domestic banks.

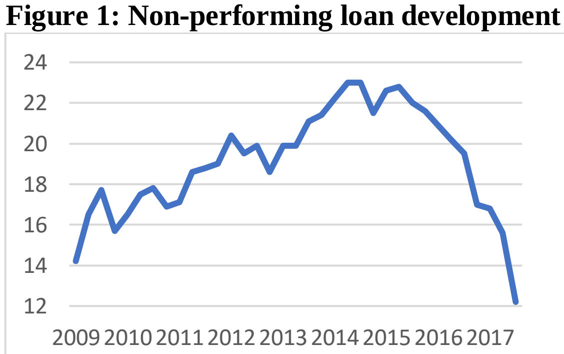
**Table 1: Financial Sector Structure (Q2 2017)**

| | Assets (RSD bn) | Share (%) |
|---|---|---|
| **Financial sector** | 3,556 | 100 |
| *(in % of GDP)* | *83.0%* | |
| **Banking system** | 3,221 | 90.6 |
| State-owned banks | 534 | 15.0 |
| Local private banks | 263 | 7.4 |
| Foreign-owned banks | 2,424 | 68.2 |
| **Non-bank financial institutions** | 335 | 9.4 |
| Insurance companies | 231 | 6.4 |
| Pension funds | 34 | 1.0 |
| Leasing companies | 70 | 2.0 |

Source: NBS

6. **The Serbian banking system was hit hard by the global financial crisis in 2008 and suffered from weak performance for several years afterwards.** In the aftermath of the crisis, the banking sector suffered from high non-performing loans (NPLs), low profitability and stagnant or declining credit conditions. NPLs as a share of gross loans grew from 11.8 percent in end 2008 to a peak of 23 percent in 2014 as a result of the reduced economic activity, rising unemployment, and local currency depreciation. Credit growth to the private corporate sector declined from 30 percent on annual basis in 2008 to negative 9 percent on annual basis in 2013. At the same time, bank profitability was eroded with average return to equity (ROE) of the banking sector declining from positive 9.6 percent in 2008 to a bottom of negative 0.4 percent in 2013. In spite of these developments, the system remained well capitalized during this period, with capital adequacy ratios exceeding 19 percent.

**Figure 1: Non-performing loan development**




Source: NBS

7. **The performance of the banking sector has recently improved.** Lending activity started recovering after 2014, aided by the accelerated economic recovery and low interest rate environment. Total private sector credit grew by 5.6 percent in 2016. The authorities also took a number of measures to address high NPLs through the NPL Resolution Strategy,[3] resulting in a significantly lower

[2] The term "state-owned bank" is used in Serbia to refer to all banks in which the government has ownership interest, be it either majority or minority interest, direct or indirect, and the term is used in this document accordingly. However, of the 6 banks classified by the government as state-owned, the government owns more than 50 percent directly in 2 banks and is the largest shareholder in 2 other banks (see Table 2).

[3] In response to high NPLs, an inter-agency working group proposed a suite of actions to improve the framework for the resolution of distressed debt and encourage balance sheet clean-up by banks. Actions include enhanced supervisory oversight of

NPL ratio of approximately 12.2 percent as of end Q3 2017 (Figure 1). Sector profitability steadily improved over the past years with ROE of 11 percent as of end Q3 2017. The sector continues to be resilient, with an asset quality review (AQR) that was completed by the National Bank of Serbia (NBS) confirming that average capital adequacy exceeds 20 percent.

8. **The Republic of Serbia has direct[4] ownership stakes in four banks operating in Serbia**: Komercijalna Banka, Banka Postanska Stedionica (BPS), Srpska Banka, and Jubmes Banka (Table 2). It also has indirect ownership in MTS Banka and Jugobanka-Jugbanka Kosovska Mitrovica and in one savings bank, Tesla Banka, which operates in Croatia.[5] The banks with ownership interest account for approximately 17 percent of assets of the Serbian banking system as of June 2017 (Table 2).[6] Of the banks with state ownership, only Komercijalna Banka[7] and BPS are considered to be of systemic importance.

**Table 2: Banks in which the Republic of Serbia (RoS) has ownership interest (June 2017)**

| Bank | RoS participation in ownership (%) | | | Total Assets (RSD bn) | Market Share (%) | Rank (by Assets) |
|---|---|---|---|---|---|---|
| | Direct | Indirect | Total | | | |
| Komercijalna Banka a.d. | 41.74 | 0.42 | 42.16 | 374.0 | 11.6 | 2 |
| Banka Poštanske Štedionice a.d. | 74.56 | 25.44 | 100.00 | 130.6 | 4.1 | 9 |
| Srpska Banka a.d. | 76.68 | 23.31 | 99.99 | 12.4 | 0.4 | 23 |
| Jubmes Banka a.d. | 20.10 | 11.04 | 31.14 | 9.3 | 0.3 | 27 |
| MTS Banka a.d. | 0.01 | 64.46 | 64.47 | 6.4 | 0.2 | 29 |
| Jugobanka Jugbanka a.d. K. Mitrovica | 0.00 | 34.53 | 34.53 | 1.3 | 0.0 | 31 |
| **Total banks with RoS ownership interest** | | | | **534.0** | **16.6** | |

Source: NBS, MoF

9. **Although the performance of the banking system has improved, the state-owned banking sector continues to be plagued by losses.** The majority of state-owned banks suffered considerable losses in the past years (see Figure 2), but their performance has recently improved, partly as a result of stronger oversight by the Ministry of Finance and the implementation of the government's strategy for state owned banks, which were supported by the Deposit Insurance Strengthening Project. In 2017, it is expected that most banks with direct state ownership will be profitable.

provisioning practices, an improved framework for the valuation of banks' real estate collateral, insolvency reforms, the removal of obstacles to the sale of NPLs, and tax amendments that seek to reduce disincentives for write-offs.

[4] Direct ownership refers to shares owned by the Republic of Serbia. Indirect ownership refers to shares owned by state or provincial institutions, or bankruptcy estates of banks administered by the Deposit Insurance Agency.

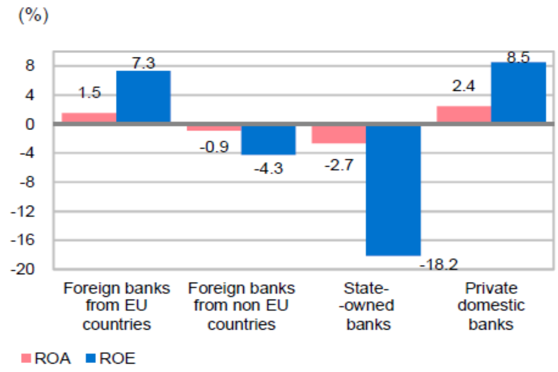
[5] MTS Banka is 81.9 percent owned by Telekom Srbija, a.d. Beograd, which is majority owned by the Republic of Serbia. As of August 2017, the largest shareholders of Tesla Banka are the Development Fund of the Republic of Serbia (26.5 percent) and the Government of the Autonomous Province of Vojvodina (23.6 percent).

[6] MTS Banka has 0.2 percent market share of total banking assets in Serbia. Tesla Banka has less than 1 percent market share of the Croatian banking system assets.

[7] The biggest shareholders of Komercijalna Banka are the Republic of Serbia (41.7 percent), EBRD (24.4 percent), and IFC (10.1 percent).

10. **In spite of the overall improvement in the asset quality in the banking system, NPLs in the state-owned banking sector continue to be a concern.** Although NPLs have declined considerably in the banking system overall, including in state-owned banks, most state-owned banks continue to have higher NPLs than sector average: Komercijalna has an NPL ratio of 16.7 percent, BPS has 31.3 percent, Jubmes and Srpska have 4.7 percent and 28.5 percent NPL ratios respectively as of end September 2017.

**Figure 2: Bank profitability by ownership (2016)**




Source: NBS.

***Role of the State in the Financial Sector***

11. **In addition to state-owned banks, there are several other SOFIs in Serbia that play a significant role in the financial sector.** It is estimated that SOFIs have a market share of about 18 percent in the total financial sector (see Table 3). In addition to the state-owned banks, the government has ownership interest in the largest insurance company, Dunav Insurance, and two development finance institutions (DFIs), the Development Fund and the Serbian Export Credit and Insurance Agency (AOFI).

**Table 3: Share of SOFIs in Financial Sector**

| | Assets (RSD billion) |
|---|---|
| State Owned Banks | 534.0 |
| Dunav Insurance | 38.7 |
| Development Fund | 60.4[1] |
| AOFI | 9.8 |
| Total Assets of SOFIs | 642.9 |
| *Share of SOFIs in total financial sector* | *18%* |

Source: NBS, Financial Institutions. Data for banks and Dunav are as of Q2 2017, data for the Development Fund and AOFI are as of Q3 2016.
[1] Note: DF assets are gross assets held on the balance sheet. Total off-balance sheet assets amount to RSD 204.8bn.

12. **SOFIs, with implicit state guarantees, present a contingent fiscal liability in case they become undercapitalized.** In the past five years, the government has spent over EUR 800 million on SOFIs. As an example, in 2012 and 2013, two state-owned banks – Agrobanka and Razvojna Banka Vojvodine – were resolved and the total cost of these two failures exceeded EUR 500 million, while Dunav Insurance and two other state-owned banks have received over EUR 150 million in capital support in total during the past three years.

13. **SOFIs are a significant source of soft budget support to SOEs.** For example, state-owned banks and DFIs have been used to lend to public enterprises that cannot borrow from private banks or, if they can borrow, face higher borrowing costs. In this way, they essentially function as an off-budget financing mechanism for the corporate sector, including public enterprises. Political interference has led to unsound business decisions in several SOFIs, e.g. poor lending practices to both private and public sector enterprises in the case of banks and the non-deposit taking institutions, and overstaffing and excessive involvement in non-core activities.

14. **Recognizing the material risks that exist in SOFIs, the government has developed a reform strategy for SOFIs and requested the World Bank's support via a results-based IPF to help implement this strategy.** The reform strategy aims to divest from those SOFIs that the government has chosen not to retain, and improve the financial and operational performance of the remainder in order to minimize fiscal risks from SOFIs and ensure that soft budget support from SOFIs to the SOE sector in the form of loans in arrears is minimized going forward. Given that these reforms are politically sensitive and have been challenging to implement in the past, the government would like the World Bank to support their implementation together with support from other IFIs, especially the IMF, to ensure that the momentum behind the reform process is maintained. SOE reform more generally is outside the scope of this operation, but is supported by the World Bank and other partners through different means.

***Reform of State Owned Banks***

15. **The government decided to restructure the state-owned banking sector by reducing the number of state-owned banks with direct ownership to one (BPS), while divesting from the other four banks.** The largest state-owned bank, Komercijalna Banka, is in the process of being privatized. Both EBRD and IFC have minority stakes and the privatization process has already commenced. The government decided to: (a) sell its stake in Jubmes Banka; (b) restructure and eventually sell Jugobanka[8]; and, (c) transform Srpska Banka into a non-bank specialized defense industry financing institution. The government is in the process of formally adopting a conclusion that outlines the process and timeline for divesting from these three banks and authorizing the MoF to initiate the divestment process. The only bank that the government has decided to retain for the medium-term is BPS.

16. **The major focus of the government's state-owned bank reform agenda is on ensuring the viability and sustainability of BPS**. The government has chosen to retain BPS in the medium-term due to its importance for access to financial services in the country. Traditionally, BPS primarily served as a retail bank that had a vital role in access to finance with its large network of 173 branches and presence at 4,000 post offices. BPS has one of the largest customer franchises in Serbia with more than 2.8 million customers, including a large number who primarily utilize the bank as a means to obtain their pensions and other government social security payments. The bank has historically been a highly liquid, low risk bank, with limited lending operations. Privatization will be considered at some stage, but only once it is properly restructured as outlined below and when the sale does not pose a risk to access to financial services (payments, deposit accounts, etc.) especially in the underserved population segments and regions (e.g., any new buyer is likely to immediately proceed with a substantial reduction in the branch network).

17. **BPS is a troubled bank that requires significant restructuring.** From 2012 on, BPS rapidly grew its corporate portfolio and also involuntarily acquired large amounts of corporate loans from failed banks, with the result that the bank rapidly reoriented itself from being primarily a retail lender to primarily a corporate lender. The expansion of the corporate lending portfolio was undertaken without first putting in place proper policies and procedures to manage the risks of large corporate lending which resulted in large credit losses, the majority of which were incurred on corporate loans originated by BPS itself. A combination of poor governance, poor risk management, and political interference in the lending decisions thus resulted in the rapid growth of corporate NPLs. Total NPLs were at 42 percent of gross loans by end-2016, with 95 percent of NPLs being corporate loans. In December 2016, BPS recorded a one-time

[8] Regarding Jugobanka, the divestment of the bank is politically difficult even though it is a very small bank due to its ongoing banking presence in Kosovo and Metohija and it must be restructured before sale due to substantial assets and claims held off balance sheet that would deter investment by any potential acquirer. The exact timing of the divestment will likely become part of the broader political dialogue between Serbia and Kosovo and Metohija.

impairment charge of about RSD 9 billion and suffered losses of RSD 6.3 billion as a result of recording provisions required to fully cover the credit risk of its corporate loan portfolio.

18. **The government has prioritized restructuring BPS to minimize fiscal risk and develop a viable financial institution.** In August 2016, the government adopted a conclusion[9] on guidelines for the bank's new business strategy. This requires that the bank exit the medium[10] and large corporate lending business, limit its lending to SOEs which may not exceed 75 percent of the amount of public sector deposits at the bank, and focus on serving the retail and micro and small business markets. The government conclusion also calls for improvements in the corporate governance and risk management systems in the bank, reduction of NPLs, and reorganization of the operations of the bank (e.g., HR, IT, etc.) in alignment with the new strategy. The key element of the strategy is that it puts in place an independent risk management function and pairs this with hard and rapidly declining ceilings on the corporate lending business and also caps lending to SOEs. Since end 2016, as a result of implementation of the government's conclusion, BPS has been able to reduce its level of net NPLs to net loans from 16.5 percent as of Q3 2016 to 4.9 percent as of Q3 2017. In December 2017, BPS formally adopted its new strategy and three-year business plan in line with the conclusion. The government would like the World Bank to support the further restructuring of BPS to ensure that the recent positive developments are maintained and that large procurements, i.e. for the core banking system (see further below) are handled in line with World Bank guidelines.

***<u>Other State Owned Financial Institutions</u>***

19. **Other state-owned financial institutions include most importantly the Development Fund (DF) and AOFI.** These non-deposit-taking financial institutions provide financial support to enterprises. The DF and AOFI have developmental mandates and provide direct loans, guarantees, export credit insurance, factoring, and export financing to enterprises. Together the gross loans and guaranteed portfolio outstanding on the balance sheets of these two institutions are equivalent to about 7 percent of total loans outstanding in the entire (commercial) banking sector. In addition, the DF channels considerable budget funds through off-balance sheet structures to borrowers.

20. **The government is currently reviewing the institutional framework for providing developmental finance in Serbia.** Although significant public resources are spent on financial support programs through the DF and AOFI, the current system is complex, non-transparent and inefficient. Limited oversight has resulted in shallow understanding on behalf of the government on the activities and performance of the institutions and limited accountability of the institutions themselves. Both institutions officially report to the Ministry of Economy (MoE) with no oversight by the NBS.

21. **As a first step, the government launched independent external assessments of both institutions, which revealed significant operational weaknesses.** The assessments were undertaken by internationally respected external consultants who reviewed not only the portfolios but also the institution's strategy and operational framework. The independent external assessment of the DF was completed in June 2017, and revealed significant weaknesses with high NPLs. This included a large volume of loans to SOEs as well as to private enterprises. The results for AOFI were released in August 2017 and also revealed significant problems with NPLs and a large volume of financing of SOEs. For both institutions, weaknesses in their governance, credit risk assessment, internal audit and IT were highlighted in the reports.

[9] Government Conclusion Number 24 dated August 15, 2016.
[10] Defined as a corporation with annual revenues greater than EUR 8.8 million.

22. **Following the completion of these independent external assessments, the government adopted conclusions on the DF and AOFI, mandating them to address the challenges identified.**[11] Based on the conclusions, the institutions will need to address the current problems and identify means through which future performance can be improved. Both institutions are to report to the government on the actions taken in accordance with the criteria and there will be close monitoring of the implementation of the conclusions. The adoption of these conclusions was politically highly sensitive given that they are used for specific political purposes, and shows the government's commitment to address legacy issues.

23. **The government has also decided to establish a working group to identify options for providing development finance in Serbia.** The goal is to identify the role and functions of development finance that would be suitable for the Serbian market and to propose what kind of changes are needed to align the current framework with the EU, and be able to maximize the potential of development finance without putting too much burden on the budget itself. The working group will also need to propose decisions on the future of the DF and AOFI and the need to create an appropriate supervisory framework, including application of strict asset valuation rules, disclosure of audited financial statements under IFRS, and an assessment of what institution is best positioned to exert oversight.

24. **The Serbian government also owns the largest state-owned insurance company, Dunav Osiguranje (Dunav).** Dunav has experienced low profitability due to a long history of overstaffing, investment in non-core business activities, and under-pricing of mass retail insurance products, all of which have been exacerbated by political interference. The government has decided to explore privatization options for the company, which would contribute to the development of the insurance industry and eliminate fiscal risks.

25. **The government is focused on improving the oversight and corporate governance arrangements for all SOFI's.** The Deposit Insurance Agency (DIA) was responsible for oversight and privatization of state-owned banks and insurance companies based on the DIA Law prior to April 2015. In practice, this oversight function was relatively weak and coupled with weak corporate governance contributed to the poor performance of many SOFIs. Through changes to various laws, the MoF is now responsible for the oversight of SOFIs since April 2015.[12] However, building the capacity to perform this function will still require significant resources and effort going forward.

26. **Given that NPLs have become a potential source of systemic risk, the authorities developed a comprehensive NPL Resolution Strategy.** Implementation of the strategy required complex inter-institutional coordination, and two action plans – one developed by the NBS and the other by the government of the RoS. The NPL working group consists of representatives of all relevant institutions, supervises the implementation of the strategy and identifies problems that should be addressed during implementation. The level of NPLs decreased significantly after the adoption of the strategy, and in the period of its implementation, both in nominal as well as in relative terms (cp. Figure 1).

27. **Based on the success of the NPL Resolution Strategy, the government is reviewing the need to systematically approach the issue of recovering bad assets from failed banks and other SOFIs.** To that end, the update of the NPL Resolution Strategy, which will take place in 2018, will include guidance on potential resolution mechanisms, the current legislation and the need to amend or introduce new legislation to allow alternative approaches to accelerate and complete NPL resolution for failed banks as

[11] Government Conclusions SC 05 No 00-345/2017 (DF) and SC 05 No 00-347/2017 (AOFI), dated December 5, 2017.
[12] There is one exception, as MTS Bank is a subsidiary of Telekom Srbija, a.d. Beograd, the Ministry of Telecom oversees the parent company and has formal responsibility for the subsidiary bank.

well as non-banking financial institutions. The updated strategy should propose a model and provide a supplementing action plan that would resolve existing problems and enable the final settlement of creditors.

### C. Higher Level Objectives to which the Project Contributes

**28. The financial sector results-based IPF is fully congruent with the Country Partnership Framework (CPF) for FY16-20 focus areas (Focus Area 1: the "Economic governance and the role of the state" and Focus Area 2: "Private sector growth and economic inclusion").** Focus area 1 specifically addresses constraints to the effectiveness of economic governance, including those related to the government's role in the financial sector as the owner of key institutions. This project will directly contribute to the goal of supporting sustainable public expenditure management in this CPF area. Focus area 2 addresses significant constraints to private sector development and economic inclusion, including those related to the financial sector. This project will directly contribute to the goal of assisting in creating a more stable and accessible financial sector.

## II. PROJECT DEVELOPMENT OBJECTIVES

### A. PDO

**29. The Project Development Objective is to improve the performance of Banka Postanska Stedionica AD Beograd and promote the reform of Development Finance Institutions and Other State-Owned Financial Institutions.**

**30. The project aims to support the reform of SOFIs** by contributing to the government's reform program through executing a strategy for SOFIs that decreases fiscal costs, minimizes the potential for soft budget support to SOEs, improves the performance of those institutions that the government chose to retain, supports the divestiture of all others, and develops a strategy for development finance and further NPL resolution.

### B. Project Beneficiaries

**31. Direct project beneficiaries are the Ministry of Finance and those SOFIs that the government has decided to retain.** Indirect project beneficiaries include taxpayers, given the lower fiscal burden from SOFIs, private financial institutions by creating a more leveled-playing field, underserved users of financial services insofar as the reformed SOFIs will improve targeting and focus on underserved groups, as well as individuals and businesses borrowing and banking with more efficient SOFIs.

### C. PDO-Level Results Indicators

**32. The PDO indicators include the following:**

- BPS gross amount of performing credit exposures to medium and large private sector enterprises[13] is reduced compared to end-2016
- BPS gross NPLs are reduced compared to end-2016

[13] "Medium and large private sector enterprises" are defined as enterprises with annual revenues greater than EUR 8.8 million.

- State-owned NPLs are reduced compared to end-2016

**33. These PDO level indicators are underpinned by a series of disbursement-linked indicators and results (DLIs/DLRs) that will be utilized to facilitate the achievement of project objectives, as well as intermediate results indicators.** Annex 1 presents the DLIs and DLRs, the intermediate indicators, and targets for disbursements.

## III. PROJECT DESCRIPTION

### A. Project Components

**34. The project includes two components that support the authorities in implementing their reform program for SOFIs:**

1. A results-based component of EUR 27,969,750 (US$ 34,875,000 equivalent) that supports the reform of SOFIs based on the achievement of DLIs/DLRs in line with the government's reform program;

2. A technical assistance and investment component of EUR 12,030,000 (US$ 15,000,000 equivalent) that aims at strengthening institutional capacity and finances needed goods and services to support the achievement of DLIs/DLRs.

**35. Under both components, the project focuses on supporting the government in two major elements of its reform program:** (i) restructuring BPS, which is the core part of the government's state-owned banking sector reform strategy; and (ii) supporting the MoF in improving the oversight of SOFIs, implementing the government's strategy for state-owned banks, divest from SOFIs that were not decided to be retained, develop a forward-looking strategy on development finance, and continue to make progress on the resolution of NPLs.

**Component 1: Support the Reform of State Owned Financial Institutions (EUR 27,969,750)**

**36. Under this component, evidence of achievement of a series of DLIs/DLRs in the two reform areas supported by the project will be required prior to reimbursing Eligible Expenditure Programs (EEPs).** The EEPs under the project will include selected salaries for the Ministry of Finance and Ministry of Economy, as both are responsible for oversight of selected SOFIs as well as access to finance issues and the MoF is managing contingent fiscal liabilities, which SOFIs contribute to. A summary of the DLIs/DLRs is included below, with details and the matrix of DLIs/DLRs included in Annex 1. The DLIs/DLRs have been developed through extensive conversations with the MoF, MoE, SOFIs, and relevant stakeholders.

1. **Restructuring BPS.** Providing financing for an Eligible Expenditure Program to support the Borrower in the restructuring of BPS, including, *inter alia*: (i) reorienting BPS towards retail and micro and small business lending in line with a new business plan; (ii) exiting the corporate lending business; (iii) decreasing its operations with SOEs; and (iv) reducing its stock of NPLs.

2. **Development Finance and other State-Owned Financial Institutions Reform.** Providing financing for an Eligible Expenditure Program to support the Borrower's SOFI reform program, including, *inter alia*: (i) implementing the reforms embedded in the Development

Fund Conclusion and the AOFI Conclusion; (ii) developing a strategy on Development Finance Institutions; (iii) implementing the Borrower's strategy for State-Owned Banks; and (iv) improving the recovery of bad assets from SOFIs.

**Component 2: Strengthen Institutional Capacity (EUR 12,030,000)**

37. **This component will finance technical assistance (TA) and investments in critical areas that are needed to support the achievement of the DLIs/DLRs.** The activities supported by the project are outlined below, with further details, including the initial procurement plan, included in Annex 2.

1. Provision of technical assistance and acquisition of equipment in critical areas to support the achievement of the DLIs/DLRs, including, *inter alia*: (a) the acquisition of a new core banking system for BPS and the provision of technical assistance to implement the BPS Conclusion, dated August 15, 2016 and BPS' business plan; and (b) the provision of technical assistance to assist MoF to: (i) carry out their oversight function over SOFIs; (ii) implement the Borrower's strategy for State-Owned Banks; and (iii) develop and implement strategies for NPL resolution and Development Finance.

2. Provision of technical assistance to support the Central Fiduciary Unit (CFU) to perform its fiduciary functions, including provision of support for financial management and procurement.

## B. Project Cost and Financing

38. **The lending instrument is Investment Project Financing (IPF).** It includes a results-based financing design with DLIs combined with a technical assistance and investment component to support the achievement of the DLIs and the PDO. This instrument was chosen because it has a track record of success in achieving results as part of ongoing reform programs and in strengthening and reforming institutions.

39. **The project will be an IBRD loan in the amount of EUR 40.1 million (US$ 50 million equivalent), implemented over a period of four years.** Component 1 (EUR 27,969,750 (US$ 34,875,000 equivalent)) will reimburse EEPs based on achieving DLIs/DLRs (Annex 1). Component 2 (EUR 12,030,000 (US$ 15,000,000 equivalent)) will disburse against statements of expenditure for goods, non-consulting services and consulting services, as well as operating costs and training. The Front-End Fee will be financed out of the loan proceeds. The Borrower will co-finance the IT system with a contribution of US$6 million.

**Table 4: Project Costs and Financing**

| Project Components | Project Cost | IBRD or IDA Financing | IBRD or IDA Financing (EUR) | Trust Funds | Counterpart Funding |
|---|---|---|---|---|---|
| Results-Based Component | US$ 34.875 m | US$ 34.875 m | EUR 27,969,750 | 0 | 0 |
| Technical Assistance Component | US$ 21 m | US$ 15 m | EUR 12,030,000 | 0 | US$ 6 m |
| Front-End Fee | US$ 0.125 m | US$ 0.125 m | EUR 100,250 | 0 | 0 |
| **Total Costs** | US$ 56 m | US$ 50 m | EUR 40.1 m | 0 | US$ 6 m |

40. **The EEPs are directly linked to the achievement of the DLRs.** The EEPs under the project will include selected salaries for the Ministry of Finance and Ministry of Economy (see Table 5). The salaries included relate to the "central" MoF (without administration) and Treasury administration, and total salaries of the MoE. The MoF and MoE are both responsible for the oversight of selected SOFIs, i.e. the MoF oversees the state-owned banks and the state-owned insurance company, and the MoE oversees the Development Fund and AOFI. They are also responsible for advancing access to finance, related to the DLRs on development finance. The MoF, including through the Treasury, is also managing contingent fiscal liabilities, which SOFIs contribute to, and this relates to the DLRs on state-owned bank reform and NPL resolution. EEPs are expected to increase about 2-3 percent per year during project implementation. Expected annual disbursements based on EEPs amount to EUR 3-12 million (US$ 4-15 million) depending on the year and are therewith lower than identified EEPs.

**Table 5: Eligible Expenditure Programs (EUR millions)**

| Economic Classification | Budget Line | 2018 |
|---|---|---|
| 411, 412 (salaries, taxes and contributions) | Ministry of Finance (select units) | 13.6 |
| 411, 412 (salaries, taxes and contributions) | Ministry of Economy (select units) | 2.0 |
| | **Total** | **15.6** |

## C. Lessons Learned and Reflected in the Project Design

41. **The design of the project builds on lessons learned from financial sector operations in Serbia, as well as from previous experience with results-based financing.** The World Bank has been involved in reforming SOFIs in Serbia for over a decade, utilizing both financial and knowledge products. A programmatic series of financial sector DPLs from 2005-2011 supported the reform of state-owned banks and insurance companies. More specifically, the operation aimed to support the government's efforts to rationalize the number of state-owned banks, among others. However, the number of state owned banks has grown since then, and in 2012 two state owned banks failed. It is important to note that this programmatic DPL series was a broad-based private and financial sector operation that covered a wide range of areas. Considering the nature of the DPL instrument, it was primarily focused on policy-based changes rather than longer-term implementation. The most recent financial sector operation in Serbia, the Deposit Insurance Strengthening Project, was designed in a similar manner to the proposed operation, with both a results-based and a technical assistance component that focused on achieving results and institutional strengthening over a longer time period. The success and lessons learned from that operation in serving as a vehicle for strengthening the Deposit Insurance Agency (DIA) and the Deposit Insurance Fund has informed the design of this operation. Results-based financing is considered to be the optimal instrument for achieving institutional strengthening, as it focuses more on achieving and sustaining results rather than policy changes.

42. **In terms of the design of the results-based financing component, lessons learned from results-based operations throughout the World Bank were incorporated.** This includes ensuring that the total number of DLIs/DLRs is limited to those that are critical milestones in the process of achieving the PDO, as too many DLIs/DLRs can complicate project implementation and supervision. In addition, the inclusion of a TA component to support the achievement of the DLIs/DLRs is also seen as an important aspect for successful project design and implementation of results-based operations.

43. **The technical design of the project was informed by previous World Bank engagements related to SOFIs.** This includes both financing and knowledge products. Lessons learned from these

experiences were incorporated into the design of the DLIs/DLRs and the technical assistance and investment activities related to the restructuring efforts that are financed by the project. Some of these include the focus on corporate governance improvements and the importance assigned to putting in place an appropriate IT system as part of a restructuring effort of a SOFI.

# IV. IMPLEMENTATION

## A. Institutional and Implementation Arrangements

44. **The Central Fiduciary Unit (CFU) within the MoF will be in charge of fiduciary responsibilities for the project, while the MoF will be the primary implementing entity and responsible for all technical aspects of implementation.** The CFU is a new unit which has been established as part of the Serbia Inclusive Early Childhood Education and Care Project, and is envisaged to be responsible for managing the procurement and financial management for several WB projects going forward. The CFU will have overall financial and procurement responsibilities, including providing consolidated reports on the EEPs. Costs will be shared proportionally among other projects that will be managed by the CFU[14], and the project's funds will only support the CFU consultants who specifically support this project. In addition, the MoF unit in charge of overseeing the financial sector, MoFFS, will be in charge of overseeing and executing all other project activities. Project implementation by MoFFS will rely on current resources in the unit as well as additional consultants that will be recruited under the TA component of the project. The implementation arrangements will place an emphasis on strengthening the MoFFS's capacity to oversee SOFIs through monitoring the DLIs and other aspects of the government's SOFIs strategy.

## B. Results Monitoring and Evaluation

45. **The MoFFS will be responsible for results monitoring and evaluation.** The MoFFS will be responsible for collecting data required for M&E and the coordination of project activities in accordance with the indicators included in the Results Framework (Annex 1). The CFU will submit semi-annual progress reports prepared by the MoFFS, documenting analysis of implementation progress toward achievement of the PDO, including monitoring of the results framework and DLIs/DLRs, as well an evaluation of FM and procurement.

## C. Sustainability

46. **The project will have long-term impact on both the financial sector in Serbia and the government's capacity to perform its ownership and oversight function.** The project is designed to strengthen the capacity of the government to oversee SOFIs through the achievement of DLIs and the TA component. The processes established and capacity built at the MoF through both of these components will help to ensure sustainability of results. The project will also strengthen the sustainability of SOFIs that the government has decided to retain (BPS), through the achievement of DLIs and the TA and investments to be provided. Improving the performance of BPS will also decrease banking sector distortions while contributing to financial sector stability. Following through on the government's strategy on state-owned banks, which includes the privatization of several banks, will make the banking sector more market-based

[14] Eventually this will include multiple projects, but as of now only the Early Childhood Education and Care project and this proposed project will be managed by the CFU.

and will contribute to increased competition and growth in the sector. Finally, further reducing the level of NPLs in the financial system, and especially addressing the legacy issues associated with state-owned NPLs, will help increase credit activity and spur banking sector development.

### D. Role of Partners

47. **The project design and implementation is closely aligned with the IMF program.** The WB is working closely with the IMF, as reforming SOFIs is also included in the current SBA that will end in February 2018, and is expected to form part of a successor program currently under discussion. The actions supported by this project are fully aligned with the high-level policy priorities outlined in the IMF SBA. The IMF has also supported the NBS in upgrading its supervision approach, which is related to the project. Regarding access to finance issues and the overall role of SOFIs, the World Bank is working closely and coordinating activities with other development partners such as the EC, EBRD, EIB, KfW, SECO, and USAID. Regarding IFC, considering the investment interest in the largest majority state-owned bank in Serbia, Komercijalna, the World Bank Group Finance, Competitiveness and Innovation (FCI) team responsible for this project has not engaged in substantive discussions related to the privatization of the bank nor are any actions related to the privatization included in the project to minimize the potential perceived conflict of interest.

## V. KEY RISKS

### A. Overall Risk Rating and Explanation of Key Risks

48. **The overall project risk is substantial.** While there is broad consensus for reforming SOEs in Serbia, including those in the financial sector, entrenched interests could undermine these efforts. The preparation of the project has been delayed several times due to interference in the reform program that is being supported by the operation. Although the project design tries to minimize this risk as much as possible, it is important to note that this remains material in spite of these measures. The political and stakeholder risks are therefore rated as substantial. The expiring SBA with the IMF and yet to be concluded discussions about a successor program adds to the risk as the IMF has been an important partner in ensuring that reforms are implemented. Regarding mitigating measures, public government conclusions adopted by the cabinet were required for the restructuring of BPS to ensure sufficient commitment to the reform program supported by the operation. In addition, the new executive board of BPS was hired in line with previous agreements prior to proceeding with the project.

49. **The technical design risk is rated as high.** While there is broad agreement on the reform efforts required at the current point and the government has shown commitment through agreeing on substantial Conclusions on BPS, the DF and AOFI, progress has varied over the course of project preparation. The design of the project also had to be changed during preparation given the limited progress with the privatization of Dunav. The project design was modified to reflect the risks inherent in the project, including through the sequencing of reforms, and the team has established strong technical working relations with counterparts to mitigate against this risk to the extent possible. The strong technical assistance component also provides mitigating measures. The incorporation of the IT procurement for BPS into the project contributes to the high-risk rating. The team has been complemented with an IT procurement as well as core banking specialist to mitigate this risk and to start the procurement process already prior to project effectiveness.

50. **The institutional capacity for implementation and fiduciary risks are substantial.** The procurement risk is assessed as "high". The CFU was established within the MoF in October 2017 to provide fiduciary support to World Bank-financed projects in Serbia. It has three staff at the moment selected on competitive basis: the Director, Procurement Specialist, and Financial Management Specialist. The pilot project to be implemented under the CFU is the "Inclusive Early Childhood Education and Care" which was ratified by Parliament in November 2017 and is awaiting effectiveness. In addition, a Swiss TA Grant will be transferred to the CFU beginning January 1, 2018 and it is intended that this project along with another project under preparation, the Public Sector Accounting Reform TA, will also be under the CFU's portfolio. Given all these projects to be implemented under the CFU there is a high risk of staff capacity and coordination issues with the relevant implementing Ministries. The TA component under the project will support capacity building in the CFU as well as the MoFFS as a mitigating measure.

## VI. APPRAISAL SUMMARY

### A. Economic and Financial (if applicable) Analysis

51. **The successful implementation of the project would lead to lower contingent fiscal liabilities and reduced fiscal transfers to SOFIs.** In the past five years, the government has spent over EUR 800 million on SOFIs. As an example, in 2012 and 2013, two state-owned banks – Agrobanka and Razvojna Banka Vojvodine – were resolved and the total cost of these two failures exceeded EUR 500 million, while Dunav Insurance and two other state-owned banks have received over EUR 150 million in capital support in total during the past three years. In addition, it was recently revealed that the Development Fund, which has loans and advances of about EUR 1 billion (on and off balance sheet), has very high NPLs. Given the challenges SOFIs have faced in the past, it would need to be expected that fiscal transfers would continue to be needed in the future to keep them afloat if no action was taken. By supporting the government in the implementation of its strategy related to state-owned banks, the project would contribute to lower contingent fiscal liabilities and reduced risk on future fiscal expenditures related to these institutions.

52. **The project will also support the government in generating revenue through privatization of certain state-owned banks as well as through recovering state-owned NPLs.** Estimations regarding the values that can be expected are challenging to determine at the current point. The book value of SOFIs to be privatized amounts to about EUR 622 million as of June 2017.

53. **The project would also help level the playing field in the banking sector.** SOFIs create market distortions, which are leading to further indirect costs, but are difficult to quantify. This may indirectly also improve the overall performance in the banking system as well as confidence in the overall financial system, but the causal chain would not allow for direct measurement of such potential impact.

### B. Technical

54. **The design of the project and each of the two focus areas is based on detailed assessments that have been done for each of the SOFIs as well as an analysis of the current oversight of these institutions by the government.** These assessments, combined with international best practice related to SOFIs, served as the basis for the design of the DLIs/DLRs and TA as outlined below. Additional details can be found in Annex 1.

**Focus Area 1 – Restructuring BPS**

**55. BPS has undergone three independent diagnostics in recent years, and the findings from these reports serve as the basis for the restructuring strategy for BPS.** This includes an independent diagnostic conducted at the direction of the MoF in 2013, and a more detailed independent diagnostic conducted in 2015 at the direction of the MoF in order to identify the size of capital injection needed at the time. In addition, the NBS conducted an AQR in 2016. These findings, along with detailed assessments done by the WB on specific areas (e.g., corporate governance, risks management, etc.) during the preparation of the project served as the basis for the conclusion that the government adopted to govern the restructuring of BPS in 2016 and that is supported by this project. The main elements of the conclusion are:

- *Reorientation of Business Strategy:* BPS was primarily a retail bank until the end of 2011. However, from 2012 on, the bank absorbed assets from three failed state-owned banks and rapidly reoriented itself towards large corporate lending. The bank did not have the appropriate internal control systems and processes in place to develop this corporate business and mitigate political influence on its credit decision-making. AQRs revealed the depth of the problem: NPLs reached 42 percent of gross loans by late 2016, with 96 percent of NPLs being corporate loans. As a result of the government conclusion, BPS was required to fully provision its NPLs and suffered a loss of RSD 6.3 billion for 2016. The diagnostic studies also revealed the inappropriate role that BPS was playing in financing SOEs, because the bank was redeploying deposits from profitable SOEs to provide financing to loss-making SOEs, and also using its liquidity to finance other “social goods” (e.g. BPS purchased bonds of the Republika Srpska in Bosnia and Herzegovina). The government conclusion put in place requirements to immediately and permanently cease lending to large corporate borrowers, established quantitative targets for running off the existing corporate portfolio, placed a hard cap on SOE lending going forward, and required BPS to focus on building up the retail and micro and small business segment. The DLIs/DLRs and TA included as part of this project support the execution of this strategy, the achievement of quantitative targets for reducing the size of the corporate portfolio, and capping of the bank’s exposure to SOEs.

- *Governance and Risk Management Reform:* The AQRs of BPS identified weaknesses in corporate governance and risk management as the main causes of the bank’s bad experience with corporate lending. The expansion of the corporate lending portfolio was undertaken without first putting in place adequate capacity for independent credit appraisal and risk management. These deficiencies together represented a significant corporate governance failure by the Board of Directors (BoD), that were not able to ensure the prudent operation of the bank. In addition, a review of the corporate governance framework identified significant gaps in the selection process for BoD members and a lack of BoD accountability. Finally, a review of risk management procedures identified other significant deficiencies, such as a lack of an independent chief risk officer, rudimentary risk management policies and procedures, and an inappropriate and understaffed risk management organization. The DLIs/DLRs and TA included as part of this project support the provision of consulting services to support increasing the bank’s risk management capacity and quantitative targets for the reduction of corporate NPLs.

- *Operational Restructuring:* The emphasis of the operational restructuring is also based on the results of the diagnostic studies that identified weaknesses in the bank’s business processes, organization, and IT systems that limit the ability to deliver financial products and have contributed to its significant corporate NPLs. The DLIs/DLRs included as part of this project support the restructuring of BPS to enable the bank to meet the ambitious targets set in its 2018-20 strategy and business plan by realigning all aspects of its operations towards serving the retail and micro and small business markets, building new staff capacities, strengthening business processes by modernizing the bank's IT architecture, and implementing risk management policies and procedures aligned with good practice and the products the bank will offer.

**Focus Area 2 – Development Finance and other State-Owned Financial Institutions Reform**

56. **Independent diagnostic studies of the Development Fund and AOFI were conducted as a basis for reviewing the institutional framework for development finance.** The diagnostic study for the DF has been completed and revealed very high NPL levels. The results for AOFI also showed challenges with high NPLs. Based on the results of these studies, the government adopted conclusions on the DF and AOFI, mandating them to address the challenges identified. Both institutions are required to report to the government on the actions taken in accordance with the criteria and there will be close monitoring of the implementation of the conclusions. The next step for the institutions is to take decisions consistent with the quantitative and qualitative requirements of the conclusions. The DLIs/DLRs included as part of this project support these actions.

57. **To establish the role that development finance could have in Serbia, a development finance or access to finance strategy will be developed.** Based on the international experience – EU in particular – development finance can be very supportive of stronger economic growth and competitiveness of companies. A working group will be established to propose to the government options for providing development finance in Serbia. The working group will look at development finance in a more comprehensive manner, going beyond the existing institutions, and considering international best practice related to institutional structure, market failures that need to be addressed, principles of corporate governance, adequate supervision, and others. The goal is to propose what kind of changes are needed to maximize the potential of development finance without putting too much burden on the budget itself. The DLIs/DLRs and TA included as part of the project support the development of the strategy.

58. **Based on the NPL Resolution Strategy, the authorities have made considerable progress with reducing the level of NPLs, including through a "pilot project".** The aim of the pilot project was to achieve better coordination of efforts of the relevant State Creditors (MoF, DIA, BPS, DF, AOFI) in procedures of the settlement of NPLs and to gain experience with the processes involved as well as the operational and practical implications of a coordinated approach.

59. **The first pilot project included three large corporate groups at various stages of restructuring, rehabilitation or liquidation under the Bankruptcy Law and has proven effective and useful in accelerating and coordinating recovery efforts on claims of State Creditors.** In order to achieve a higher collection rate of NPLs from debtors and to improve the efficiency and effectiveness of resolution, State Creditors signed a Memorandum of Cooperation. With the support of the World Bank, the MoF has initiated a second pilot project that includes several additional corporate groups. The total loans exposure of the selected group of debtors toward one or more State Creditors amounts to EUR 110 million.

60. **Based on the success of the NPL Resolution Strategy and the pilot projects, the government would like to accelerate and complete the resolution of NPLs for SOFIs.** The update of the NPL Resolution Strategy, which will take place in 2018, will therefore include guidance on potential resolution mechanisms, the current legislation and the need to amend or introduce new legislation to allow alternative approaches to NPL resolution for active and failed SOFIs. The development of the strategy as well as the tender of NPLs based on the updated strategy will be supported by the project through DLIs/DLRs and TA.

61. **There are significant gaps in the corporate governance of SOFI as well as the ownership and oversight function.** There are deficiencies in the ownership and oversight framework for SOFIs overall, as well as significant gaps in the oversight of specific institutions (e.g., DF and AOFI). There was no clear entity responsible for performing the oversight functions for all SOFIs until the creation of the MoFFS. The project will support this unit in the MoF to carry out its legal mandate for overseeing SOFIs (e.g., TA is provided to the MoF for developing and implementing a regular oversight process for SOFIs and assisting the MoF in implementing the SOFI strategy).

### C. Financial Management

62. **The results-based financing part (Component 1) of the project is intended to finance existing expenditures included in the state budget.** EEPs will include selected salaries in the MoF and MoE, as they are responsible for oversight of SOFIs as well as access to finance issues and the MoF is managing contingent fiscal liabilities, which SOFIs contribute to. Therefore, financial management arrangements for Component 1 will rely on the country systems, including budget preparation, budget execution, financial reporting and internal controls. The payroll system within the government's institutions has been in the center of the financial management assessment. The above institutions are included in the centralized payroll system. The principal authority in charge of centralized payroll processing is the Treasury Administration of the MoF, whose statutory obligations in this regard are set out in amendments to the Law on Budget System, from 2013. The centralized payroll system was assessed under the Public Expenditures and Financial Accountability (PEFA) assessment in 2015 and it is judged to be reliable.

63. **The CFU has been established and adequately staffed, including the financial management function.** The CFU has been established on October 24, 2017 and, at the moment, it includes three employees, namely the CFU Director, Financial Management Specialist and Procurement Specialist. Capacity of the unit will be monitored with new projects starting implementation and the number of staff will be accordingly increased to match the needs. The CFU will be in charge of fiduciary (financial management and procurement) responsibilities for the project, while the MoF will be responsible for the technical aspects of implementation. The CFU will be in charge of collecting financial information on EEPs from the MoF and MoE quarterly reports and presenting those in the project Interim Unaudited Financial Reports (IFRs). Component 2 will relate to technical assistance and traditional implementation arrangements will apply. This implies that a project designated account will be opened for the project and the funds will be withdrawn to the account through advances, while the account will be replenished based on SOEs. Direct payment will be another disbursement method allowed for Component 2 for payments above the threshold determined in the DFIL. All controls and procedures, including split of responsibilities for the project, will be described in the Project Operations Manual (POM) to be prepared by the project effectiveness date.

64. **The CFU will prepare separate semi-annual interim financial reports (IFRs)** for Component 1 and Component 2 and deliver them to the Bank within 45 days after the end of the reporting period. The information for the IFR for Component 1 will be sourced from quarterly budget execution reports of the MoF and the MoE, while the IFR for Component 2 will be based on accounting records for the TA maintained in the software acquired by the CFU.

65. **Separate annual project financial statements for Component 1 and Component 2 will be audited by a private audit firm acceptable to the Bank.** The audit will be delivered to the Bank within six months after the end of the audited period. The audit will be based on ToRs for financial audit, while

responsibility to collect relevant documentation for achievement of DLIs/DLRs will rest with the MoF. Independent verification of achievement of DLIs/DLRs will be conducted by external consultants to be hired under the project. The consultants will review the credibility and accuracy of the supporting documentation provided by the MoF.

### D. Disbursement

66. **There will be no designated account opened for the results-based financing part (Component 1) and the funds are expected to flow to a foreign currency account within the NBS which the government indicates.** The funds will be disbursed based on (i) EEPs and (ii) verification of achievement of DLRs. The method of disbursement is envisaged to be reimbursement and the funds will flow to a EUR account. Statements of expenditures will be the basis for disbursement. The first withdrawal will be based on achievement of DLRs and retroactive financing of EEPs incurred prior to the signing/and reimbursement of EEPs between signing and effectiveness. The component will disburse at any point when the following conditions are fulfilled (i) EEPs as evidenced by the statements of expenditures in the amount equal or higher to the amount attributed to achieved DLRs (ii) verification and confirmation of achievement of DLRs. If the DLRs have not been met in full, partial achievement of DLR 1.3 and 1.5 may result in partial disbursement, with proportional disbursement reflecting the percentage achieved of the respective target. Disbursements withheld due to non-achievement of DLRs 1.3 and 1.5 in a given year may be released in subsequent years once the DLR is achieved, or cancelled by the Bank. Up to 25 percent of the total amount for the component can be advanced to the borrower, which will be converted to disbursement based on subsequently achieved DLIs, which will enable new advances up to the same level.

67. **The funds for the TA (Component 2) will flow through a foreign currency designated account.** A Designated Account (DA) will be opened in the NBS and used solely for inflows and outflows related to Component 2 of the project. For local currency payments, the funds will be converted to a sub-account within the Single Treasury Account (STA) opened solely for the purpose of use of project funds for payments in local currency. The disbursement method used for this part will be primarily advances, with methods of direct payment and reimbursement being also allowed as alternatives. It will be a EURO account. Disbursement will follow a traditional model and be based on statements of expenditures. The CFU will remain responsible for the preparation of financial reports for all of Component 2 of the project.

### E. Procurement

68. **The procurement risk rating is assessed as "high."** The CFU within the MoF will implement the procurement activities under the project. The CFU will implement the Early Childhood Education Project (awaiting effectiveness) and the Swiss TA on Reform on Financial Reporting effective January 1, 2018. The Grant Agreement for the Swiss TA is being amended to reflect the transfer of the PIU from the DIA to the CFU. In addition, the Public Sector Accounting Reform TA under preparation will also be under the CFU. Given that four projects are expected to be implemented by the CFU by mid-2018, CFU staffing should be reviewed to ensure that it has sufficient and qualified staff to implement procurement and financial activities under the projects. For this specific project, CFU staff will maintain close coordination with the technical staff of MoFFS.

69. **All goods, consulting services, and non-consulting services required and to be financed out of the proceeds of the project** shall be procured using procurement arrangements and methods that are set out in the WB Procurement Regulations for Borrowers under Investment Project Financing dated July 1, 2016.

### F. Social (including Safeguards)

**70. The project will not have adverse impacts on land**. The activities supported by the project will not involve land acquisition or physical relocation. The project does not trigger OP4.12. The proposed components aim to improve the oversight and performance of SOFIs that the government has chosen to retain and the improvement of organizational functioning of BPS.

**71. The project will have positive impacts on BPS employees by introducing modern human resources and IT systems.** It is expected that BPS will hire new staff with financial risk management expertise. The new human resources system will include a modern approach to career management, training and development, and performance management. However, the restructuring process of BPS associated with Component 2 may potentially identify a need to reduce the number of staff in business functions which will be automatized and rightsized. BPS has 1997 employees (68 percent women) and a large majority (59 percent) have high school level education. The BPS plans to rely on natural attrition and retirement eligibility as methods for staff reduction, since about 15 percent of employees will meet conditions for retirement (old age and early pension) in the period from 2017 through 2020. If there is a need to reduce staffing beyond natural attrition, this risk will be known during project implementation, and downsizing would be carried out during project implementation. In instances where there may be a residual risk of staff rightsizing, this will be managed in accordance with applicable labor law and collective agreements, and all other applicable national legislation as well as good international practice. The applicable labor law and collective agreement includes a requirement for consultations with unions and the national employment service. The labor law provides a definition of staff redundancies in instances of organizational and technological changes. The existing collective agreement provides options for voluntary separation with incentive severance payment, and also includes a procedure, selection criteria and amount of severance payment for involuntary separation (which is above the minimum prescribed by the labor law). The previous experience with staff reductions at BPS indicates that it was carried out on voluntary basis with incentive severance payments. In instances of staff redundancies, the Borrower will inform the Bank and prepare a retrenchment plan acceptable to the Bank and the Borrower will carry out consultation with unions. The proceeds from the World Bank loan will not be used to finance severance payment. If staff reductions occur during project implementation, the Borrower will submit an implementation report to the Bank after the completion of the process.

**72. Citizen Engagement.** As part of project preparation, an outreach session was held with businesses and organized by a local business association. During implementation, such outreach sessions will continue to be organized to keep beneficiaries and businesses informed and engaged in the reform process and to close the feedback loop. The project also supported the enactment of government decisions for key elements – the strategy for BPS and strategy for state-owned banks – that were publicly disclosed in order to ensure transparency about the government’s decision related to these institutions.

**73. Gender.** Given the nature of the project, there is no gender specific impact from the project and the project design did not focus on gender disparities in access to finance in Serbia. While gender disparities exist in access to finance in Serbia, they are insignificant. The Constitution of Serbia envisages equal rights of men and women with regard to bank loans and other financial credits. However, in most cases, a condition for obtaining loans is the possession of certain property and since there is a lower proportion of women than men among the owners of collaterals, in practice women are placed in a less favorable position in relation to men. The disparity in owning collateral is wider in rural areas with women owning only 18 percent of agricultural holdings (OECD, Gender, Institutions and Development Database, 2014). According to the WB's global FINDEX database, in 2014, women slightly lagged behind men with regard to access to savings accounts, with only 8 percent of women compared to 10 percent of men. Similarly, 10 percent of men borrowed from a financial institution in 2014, compared to 8 percent of women. On the other hand, Serbia reached gender parity in accessing bank accounts, as 83 percent of both women and men have an account at a financial institution.

### G. Environment (including Safeguards)

**74. The project is rated environmental category C in accordance with the World bank OP/BP 4.01 on Environmental Assessment.** In respect to its activities, the project is environmentally-neutral and has no impacts and risks associated to environmental performance. The project does not trigger any environmental safeguard policies.

**75. Climate Co-Benefits.** The project has been screened for potential climate co-benefits, but immediate opportunities could not be identified. As part of the work towards a development finance strategy, the working group will deliberate to what extent the promotion of energy efficiency and environmental protection should be part of the development finance framework in Serbia. While it cannot be determined at the current point whether climate aspects will feature in the strategy, awareness can be raised through the project regarding the importance of these topics.

### H. WB Grievance Redress

**76. Communities** and individuals who believe that they are adversely affected by a World Bank (WB) supported project may submit complaints to existing project-level grievance redress mechanisms or the WB's Grievance Redress Service (GRS). The GRS ensures that complaints received are promptly reviewed in order to address project-related concerns. Project affected communities and individuals may submit their complaint to the WB's independent Inspection Panel which determines whether harm occurred, or could occur, as a result of WB non-compliance with its policies and procedures. Complaints may be submitted at any time after concerns have been brought directly to the World Bank's attention, and Bank Management has been given an opportunity to respond. For information on how to submit complaints to the World Bank's corporate Grievance Redress Service (GRS), please visit http://www.worldbank.org/en/projects-operations/products-and-services/grievance-redress-service. For information on how to submit complaints to the World Bank Inspection Panel, please visit www.inspectionpanel.org.

# VII. RESULTS FRAMEWORK AND MONITORING

**Results Framework**
COUNTRY : Serbia
State Owned Financial Institutions Reform Project

### Project Development Objectives

The Project Development Objective is to improve the performance of Banka Postanska Stedionica AD Beograd and promote the reform of Development Finance Institutions and Other State-Owned Financial Institutions.

### Project Development Objective Indicators

| Indicator Name | Core | Unit of Measure | Baseline | End Target | Frequency | Data Source/Methodology | Responsibility for Data Collection |
|---|---|---|---|---|---|---|---|
| Name: BPS gross amount of performing credit exposures to medium and large private sector enterprises is reduced compared to end-2016 | | Number | 4.05 | 1.62 | Annual | BPS | Ministry of Finance, BPS |
| Description: BPS corporate lending is reduced in line with the government conclusion on BPS. Medium and large enterprises are defined as enterprises with revenues in excess of EUR 8.8 million. Baseline is RSD billion. | | | | | | | |
| Name: BPS gross NPLs are reduced compared to end-2016 | | Number | 23.32 | 11.66 | Annual | BPS | Ministry of Finance, BPS |

| Indicator Name | Core | Unit of Measure | Baseline | End Target | Frequency | Data Source/Methodology | Responsibility for Data Collection |
|---|---|---|---|---|---|---|---|
| Description: BPS gross NPLs are reduced compared to end-2016. Baseline is in RSD billion. | | | | | | | |
| Name: Reduction in state-owned NPLs compared to end-2016 | | Number | 3.10 | 1.20 | Annual | Ministry of Finance | Ministry of Finance |
| Description: Reduction in state-owned NPLs compared to end-2016. Baseline is in USD billion. | | | | | | | |

### Intermediate Results Indicators

| Indicator Name | Core | Unit of Measure | Baseline | End Target | Frequency | Data Source/Methodology | Responsibility for Data Collection |
|---|---|---|---|---|---|---|---|
| Name: BPS is in compliance with the prudential ratios set forth in Selected NBS Decisions | | Yes/No | Y | Y | Annual | BPS, NBS, independent review | Ministry of Finance, BPS |
| Description: BPS in compliance with the prudential ratios set forth in Selected NBS Decisions. This includes regulatory capital adequacy and liquidity ratios as stipulated by the National Bank of Serbia. | | | | | | | |
| Name: BPS in compliance with limit on lending to State Owned Enterprises | | Yes/No | Y | Y | Annual | BPS | Ministry of Finance, BPS |

| Indicator Name | Core | Unit of Measure | Baseline | End Target | Frequency | Data Source/Methodology | Responsibility for Data Collection |
|---|---|---|---|---|---|---|---|
| Description: BPS compliance with limit on lending to State Owned Enterprises is defined in the government conclusion on BPS as gross exposure to public sector enterprises/ total deposits from the public sector should be less than 75 percent. In addition, there are additional restrictions on the type of enterprise that can borrow under this limit: (a) only enterprises where the state or Province of Vojvodina is the founding shareholder and (b) SOEs being restructured with the involvement of an IFI. | | | | | | | |
| **Name:** BPS BoD adopts (i) strengthened risk management policies and the Executive Board adopts implementing procedures, and (ii) compensation scheme in line with approved 2018-2020 business plan | | Yes/No | N | Y | Annual | BPS | Ministry of Finance, BPS |
| Description: BPS BoD adopts (i) strengthened risk management policies and the Executive Board adopts implementing procedures , and (ii) compensation scheme in line with approved 2018-2020 business plan and the government conclusion on BPS. | | | | | | | |
| **Name:** BPS completes installation of core banking system and associated software, hardware and services | | Yes/No | N | Y | Annual | BPS | Ministry of Finance, BPS |
| Description: BPS completes installation of core banking system and associated software, hardware and services in line with business plan and government conclusion on BPS. | | | | | | | |
| **Name:** Updated NPL resolution strategy, which includes a strategy for state- | | Yes/No | N | Y | Annual | Ministry of Finance | Ministry of Finance |

| Indicator Name | Core | Unit of Measure | Baseline | End Target | Frequency | Data Source/Methodology | Responsibility for Data Collection |
|---|---|---|---|---|---|---|---|
| owned NPLs with a separate action plan, has been adopted | | | | | | | |
| Description: Adoption of updated NPL resolution strategy, which includes a strategy for state-owned NPLs with a separate action plan, per government conclusion. | | | | | | | |
| Name: Tender issued for the sale of SOFIs' NPLs, in an approximate amount of EUR 145.6 million | | Yes/No | N | Y | Annual | Ministry of Finance | Ministry of Finance |
| Description: Tender issued for the first group of state-owned financial institutions' non-performing loans in line with the NPL Resolution Strategy. | | | | | | | |
| Name: Strategy for Development Finance has been adopted | | Yes/No | N | Y | Annual | Ministry of Finance | Ministry of Finance |
| Description: Adoption of government strategy for Development Finance, per government conclusion. | | | | | | | |
| Name: Number of outreach sessions organized with business representatives as a two-way interaction | | Number | 0.00 | 3.00 | Annual | Ministry of Finance | Ministry of Finance |
| Description: Number of outreach sessions organized with business representatives. The outreach sessions are a two-way interaction when they provide tangible responses to any feedback of business representatives in previous sessions. Therefore, the sessions do not just provide information but also to ask for the participants' opinions and frequently inform them of actions taken. | | | | | | | |

| Indicator Name | Core | Unit of Measure | Baseline | End Target | Frequency | Data Source/Methodology | Responsibility for Data Collection |
|---|---|---|---|---|---|---|---|

Target Values

### Project Development Objective Indicators

| Indicator Name | Baseline | YR1 | YR2 | YR3 | End Target |
|---|---|---|---|---|---|
| BPS gross amount of performing credit exposures to medium and large private sector enterprises is reduced compared to end-2016 | 4.05 | 3.20 | 2.40 | 2.00 | 1.62 |
| BPS gross NPLs are reduced compared to end-2016 | 23.32 | 16.32 | 13.99 | 11.66 | 11.66 |
| Reduction in state-owned NPLs compared to end-2016 | 3.10 | 2.90 | 2.60 | 1.90 | 1.20 |

### Intermediate Results Indicators

| Indicator Name | Baseline | YR1 | YR2 | YR3 | End Target |
|---|---|---|---|---|---|
| BPS is in compliance with the prudential ratios set forth in Selected NBS Decisions | Y | Y | Y | Y | Y |
| BPS in compliance with limit on lending to State Owned Enterprises | Y | Y | Y | Y | Y |
| BPS BoD adopts (i) strengthened risk management policies and the Executive Board adopts implementing procedures, and (ii) compensation scheme in line with approved 2018-2020 business plan | N | Y | Y | Y | Y |
| BPS completes installation of core banking system and | N | N | N | N | Y |

| Indicator Name | Baseline | YR1 | YR2 | YR3 | End Target |
|---|---|---|---|---|---|
| associated software, hardware and services | | | | | |
| Updated NPL resolution strategy, which includes a strategy for state-owned NPLs with a separate action plan, has been adopted | N | Y | Y | Y | Y |
| Tender issued for the sale of SOFIs' NPLs, in an approximate amount of EUR 145.6 million | N | N | Y | Y | Y |
| Strategy for Development Finance has been adopted | N | N | Y | Y | Y |
| Number of outreach sessions organized with business representatives as a two-way interaction | 0.00 | 1.00 | 2.00 | 3.00 | 3.00 |

## ANNEX 1: DETAILED PROJECT DESCRIPTION

**COUNTRY: SERBIA**
**State-Owned Financial Institutions Strengthening Project**

1. **The Project Development Objective is to improve the performance of Banka Postanska Stedionica AD Beograd and promote the reform of Development Finance Institutions and Other State-Owned Financial Institutions.** The project aims to accomplish this by contributing to the government's reform program through executing a strategy for SOFIs that decreases fiscal costs, minimizes the potential for soft budget support to SOEs, improves the performance of those institutions that the government chose to retain, supports the divestiture of all others, and develops a strategy for development finance and further NPL resolution.

2. **The project includes two components that support the authorities in implementing their reform program for SOFIs:**

    1. A results-based component of EUR 27,969,750 (US$ 34,875,000 equivalent) that supports the reform of SOFIs based on the achievement of DLIs/DLRs in line with the government's reform program;

    2. A technical assistance and investment component of EUR 12,030,000 (US$ 15,000,000 equivalent) that aims at strengthening institutional capacity and finances needed goods and services to support the achievement of DLIs/DLRs.

3. **Under both components, the project focuses on supporting the government in two major elements of its reform program:** (i) restructuring BPS, which is the core part of the government's state-owned banking sector reform strategy; and (ii) supporting the MoF in improving the oversight of SOFIs, divest from SOFIs that were not decided to be retained, develop a forward-looking strategy on development finance, and continue to make progress on the resolution of NPLs.

4. **While a brief description of these components and activities supported by the project was previously provided, this section offers a more comprehensive picture of the rationale and objectives in each of the two areas.** In addition, it aims to provide specific information on how the two components of the project will support the objectives in each of the two reform areas through the results-based and TA components.

***Background on the Focus Areas***

**Focus Area 1 - Restructuring BPS**

*Background and Rationale*

5. **Banka Postanska Stedionica AD Beograd (Postal Savings Bank - BPS) was founded in 1921 as the Postal Savings Bank of the Kingdom of Yugoslavia.** The bank gradually evolved from being a purely retail savings institution to being a full-service commercial bank. In 1978 current accounts (allowing customers to make payments from their accounts) were introduced, and Giro system accounts in 1996. The bank began issuing debit cards in 1990 and opened its first ATM in 2000. In 2001, BPS became a licensed bank operating under the supervision and regulation of the then National Bank of Yugoslavia (now National

Bank of Serbia), and expanded its scope of operations to include corporate current accounts from 2003. As of Q3 2017, the bank had RSD 133.9 billion in assets and RSD 117.9 billion of deposits, representing respectively, 4.1 percent of total assets and 5.2 percent of total deposits of the banking system. At end-September 2017 the bank had 173 branches and offices and employed about 2,000 staff.

6. **Given its history and relationship with the Serbian Post, Telegraph and Telecommunications Company (PTT), the bank has a strong retail customer base.** Under the terms of a contract with BPS, PTT provides payment services for the bank's customers using its network of about 4,000 Post Offices and this network forms the primary distribution mechanism for government social payments (pensions, disability and unemployment payments). As a result, BPS has a very large number of small retail clients. More than 2.8 million people (approximately 40 percent of the population of Serbia) have a banking relationship of some kind with BPS.

Table 1: BPS Balance Sheet Evolution

*(Amounts in RSD '000)*

| **Item** | **3Q 2017** | **2016** | **3Q 2016** | **2015** | **2014** |
|---|---|---|---|---|---|
| Liquid assets | **93,837,055** | **93,325,107** | **91,416,178** | **80,517,481** | **68,949,759** |
| Net Loans and advances to customers | **32,607,911** | **30,225,564** | **39,608,339** | **42,520,438** | **37,346,896** |
| *Total corporate* | *7,238,991* | *9,692,918* | *17,854,393* | *21,575,491* | *16,658,203* |
| *Total retail* | *25,368,920* | *20,532,646* | *21,753,946* | *20,944,947* | *20,688,693* |
| **Intangible assets** | **56,241** | **78,630** | **88,020** | **113,291** | **157,858** |
| **PPE and investment property** | **4,107,124** | **4,067,298** | **4,121,540** | **3,778,674** | **3,948,118** |
| **Other assets** | **3,330,830** | **5,399,828** | **2,798,118** | **2,935,913** | **2,886,371** |
| **TOTAL ASSETS** | **133,939,161** | **133,096,427** | **138,032,195** | **129,865,797** | **113,289,002** |
| *TOTAL OFF-BALANCE SHEET ASSETS* | *17,578,160* | *9,047,676* | *9,108,035* | *11,400,456* | *13,299,365* |
| **Total deposits** | **117,932,414** | **117,707,823** | **116,663,329** | **109,306,715** | **93,036,952** |
| Insured deposits (up to EUR 50.000) | 85,048,267 | 83,465,269 | 81,648,581 | 74,160,087 | 66,877,918 |
| Uninsured deposits | 32,884,147 | 34,242,554 | 35,014,748 | 35,146,628 | 26,159,034 |
| **Other liabilities** | **2,392,151** | **3,666,693** | **2,859,110** | **2,889,825** | **2,802,463** |
| Provisions | 308,004 | 339,438 | 155,896 | 229,333 | 254,706 |
| Other liabilities | 2,084,147 | 3,327,255 | 2,703,214 | 2,660,492 | 2,547,757 |
| **Equity** | **13,614,596** | **11,721,911** | **18,509,756** | **17,669,257** | **17,449,587** |
| Share capital | 13,218,890 | 13,218,890 | 13,218,890 | 13,218,890 | 13,277,548 |
| Reserves | 2,216,721 | 2,268,768 | 2,467,807 | 1,932,471 | 1,917,469 |
| *reserves from profit* | 0 | 0 | 0 | 0 | 0 |
| Retained earnings | (1,821,015) | (3,765,747) | 2,823,059 | 2,517,896 | 2,254,570 |
| **TOTAL LIABILITIES AND EQUITY** | **133,939,161** | **133,096,427** | **138,032,195** | **129,865,797** | **113,289,002** |
| *TOTAL OFF-BS LIABILITIES* | *17,578,160* | *9,047,676* | *9,108,035* | *11,400,456* | *13,299,365* |

7. **BPS remained primarily a retail bank until 2012, when it began large-scale lending to large private enterprises**. The bank changed its strategy to very rapidly reorient itself from being primarily a retail lender to primarily a large corporate lender, with corporate loans growing threefold from end 2011 to end 2015, after which it started to go down (Table 1). The expansion of the corporate lending portfolio was undertaken without first putting in place qualified corporate lending staff and qualified staff and appropriate

policies and procedures to manage the risks of large corporate lending. These failures together represented a significant corporate governance failure. Inevitably, the combination of poor risk management and rapid growth in turn resulted in a rapid growth of corporate NPLs, with gross NPLs rising to a peak of 42.5 percent of total gross loans at end-2016, and gross corporate NPLs forming 95.3 percent of this amount.

8. **The use of BPS as a mechanism for bank resolution in 2012 and 2013 further exacerbated its asset quality problems.** In 2012-13, BPS was directed by the government to act as the acquirer for a series of purchase and assumption (P&A)[15] transactions used to resolve three failed banks (Nova Agrobanka, Razvojna Banka Vojvodina, and Privredna Banka Beograd). Two[16] of the three P&As resulted in the transfer of significant quantities of corporate loans from the portfolios of the failed banks. Failure to accurately classify or value the loans transferred from some of the banks (which reduced the amount the DIA was required to provide to compensate BPS for assuming liability for the banks' deposits) in turn resulted in a large proportion of NPLs among the transferred loans. While these transactions contributed to the high NPL stock of the bank, NPLs originated by BPS (i.e. through its own lending) remain by far the largest share in gross NPLs: 89 percent of gross NPLs and 96 percent of NPLs net of provisions at end-September 2017.

9. **The extent of the poor asset portfolio was assessed through three independent assessments, resulting in a significant loss for the bank in 2016** (Table 2). BPS' portfolio has been subject to three independent assessments in the past two years: an asset quality review (AQR) performed by an international accounting firm in 2015; the bank's external audit of its end-2015 financial statements; and, an inspection performed by the NBS in 2016. All of these assessments resulted in the identification of large volumes of unrecognized credit losses of, in the worst-case scenarios: RSD 8.46 billion (31 March 2015 AQR), RSD 8.21 billion (31 December 2015 external audit), and RSD 10.09 billion (NBS 2016 inspection, which is also the most recent). In November and December 2016, BPS' new management also reviewed the loan portfolio and identified additional losses, with the result that the bank recorded a one-time impairment charge of RSD 8.99 billion at end-December 2016 to fully sterilize credit losses in the loan portfolio. However, due to the bank's substantial reserves and capital, the impact of this provision did not threaten the bank's solvency, with the bank's capital adequacy ratio at end-September 2017 standing at 21 percent. The impact of fully provisioning credit losses has been seen in a net negative provision of RSD 365 million for the first three quarters of 2017 driven by collection of NPLs, and some reduction of individual impairments due to improved borrower performance. By end-3Q 2017 net NPLs had fallen to 4.87 percent of net loans as compared to 16.54 percent at end-Q3 2016. The bank also expects to see its capital increased by a one-off gain of about RSD 1.6 billion from the implementation of IFRS 9 that will be recorded as an increase in retained earnings at year-end, resulting in a capital adequacy ratio of between 21 and 22 percent.

10. **In addition to credit losses, the bank's financial performance has suffered due to excessive liquidity, low percentage of performing assets and low fee income.** At end-2016, BPS was excessively liquid with liquid assets representing 70 percent of total assets, revealing the bank's inability to place these assets. The bank's earnings are highly dependent on interest from government securities (about 50 percent of total assets at end-September 2017) due to the very low ratio of net performing loans to total assets (projected to be 25 percent at end-2016). The ratio of net fee income to operating income – which would be expected to be high relative to total operating income given the bank's large volume of social payments – is low at a projected 27 percent for 2016 due to the high fees charged to the bank by PTT for payments made through Post Offices (see discussion below).

[15] A method of dealing with failing banks whereby all liabilities are assumed by a healthy bank.
[16] The P&As with Nova Agrobanka and Privredna Banka Beograd.

**Table 2: BPS Income Statement Evolution**

*Amounts in RSD '000*

| | Q3/2017 | 2016 | Q3/2016 | 2015 | 2014 |
|---|---|---|---|---|---|
| **NET INTEREST INCOME/EXPENSE** | **4,344,206** | **6,034,061** | **4,663,960** | **5,715,820** | **4,515,768** |
| *interest income* | 5,349,190 | 7,758,389 | 5,986,314 | 7,966,255 | 7,993,165 |
| *interest expenses* | 1,004,984 | 1,724,328 | 1,322,354 | 2,250,435 | 3,477,397 |
| **NET FEES AND COMMISSIONS INCOME/EXPENSES** | **1,608,901** | **2,440,189** | **1,779,050** | **2,438,454** | **2,414,234** |
| *fee and commission income* | 3,454,938 | 4,975,858 | 3,660,105 | 4,887,368 | 5,000,222 |
| *fee and commission expenses* | 1,846,037 | 2,535,669 | 1,881,055 | 2,448,914 | 2,585,988 |
| **Net gains/losses from financial instruments** | **0** | **-349,661** | **3,406** | **38,422** | **84,234** |
| *debt* | 0 | -349,661 | 3,406 | 38,422 | 84,234 |
| *equity* | | | | | 0 |
| Net gains/losses from hedging | -38,471 | -28,321 | 32,652 | 266,197 | 636,017 |
| **Net exchange rate gains/losses** | **-5,570** | **149,151** | **109,817** | **223,240** | **406,429** |
| *Net exchange rate gains* | 3,275,675 | 2,505,973 | 2,140,845 | 4,833,606 | 3,538,010 |
| *Net exchange rate losses* | 3,281,245 | 2,356,822 | 2,031,028 | 4,610,366 | 3,131,581 |
| Other operating income | 32,415 | 34,591 | 28,675 | 248,842 | 72,221 |
| **Net gains/ expenses on impairment of financial assets and credit risk-weighted off-balance sheet items** | **364,502** | **-8,992,901** | **-2,319,947** | **-3,098,162** | **-2,468,616** |
| *Allowance for impairment of loans and receivables for current year* | 2,641,314 | 16,310,656 | 7,331,022 | 5,204,858 | 5,247,121 |
| *Amount of reversed indirect write-offs of loans* | 2,987,900 | 7,328,176 | 4,941,807 | 2,119,574 | 2,837,614 |
| *Provisions for off-balance sheet items made in the current year* | 57,659 | 118,372 | 29,059 | 168,912 | 111,036 |
| *Amounts of reversed provisions for off-balance sheet items* | 75,316 | 119,350 | 98,260 | 154,601 | 49,303 |
| *Direct write-off of loans, investments and other claims* | 0 | 11,855 | 380 | 12 | 30 |
| *Recovered claims that the bank wrote off directly* | 259 | 456 | 447 | 1,445 | 2,654 |
| **TOTAL NET OPERATING INCOME/EXPENSES** | **6,305,983** | **-712,891** | **4,297,613** | **5,832,813** | **5,660,287** |
| a) Salaries, salary compensations and other personal expenses | 2,296,454 | 2,173,550 | 1,648,092 | 2,134,189 | 2,333,783 |
| b) Depreciation expenses | 189,387 | 269,346 | 202,315 | 364,071 | 355,832 |
| c) Administrative and other operating expenses | 1,910,450 | 3,204,418 | 2,175,597 | 2,956,479 | 2,668,028 |
| **TOTAL OPERATING EXPENSES (a+b+c)** | **4,396,291** | **5,647,314** | **4,026,004** | **5,454,739** | **5,357,643** |
| **PROFIT/LOSSES BEFORE TAX** | **1,909,692** | **-6,360,205** | **271,609** | **378,074** | **302,644** |
| Earnings from deferred tax assets | 0 | 30,904 | | 15,249 | 14,304 |
| **RESULT FOR THE PERIOD PROFIT/LOSSES** | **1,909,692** | **-6,329,301** | **271,609** | **393,323** | **316,948** |

11. **In 2017 BPS began implementing its retail-focused strategy and this has already begun to strengthen the bank's profitability** (Table 2)**.** Greater volumes of retail lending driven by marketing, improved service, and new retail products such as pension-linked and housing loans tailored to the bank's customer base, along with reduced administrative expenses as a result of the introduction of the transparent procurement of good and services, have together produced a dramatic improvement in performance, with net income of RSD 1.9 billion at end-Q3 2017 expected to rise to RSD 3.9 billion by year end as compared to RSD 272 million at end-Q3 2016 (the "clean up provision" taken at end-2016 makes comparison of the full year results not meaningful). The very positive earnings trends seen in 2017 should be reinforced by the implementation of the bank's 2018 – 2020 business plan which will see the modernization of the bank's IT and other operating systems to support efficient delivery of an increasing number of retail and MSE banking products.

12. **As a state-owned bank with an implicit state guarantee of its liabilities, BPS presents a contingent fiscal liability for the government in the event that the bank becomes undercapitalized.** In December 2014, this contingent liability was triggered as a result of the impact of the transfers of assets

from the three failed banks and from the bank's own poor credit risk management, resulting in the government injecting a total of RSD 4.7 billion of new capital. In addition to the contingent fiscal liability, the bank has been used as an off-budget financing mechanism in two main ways:

- First, by lending to public enterprises that cannot borrow from private banks or, if they can borrow, face higher borrowing costs. Where public enterprises that cannot borrow in the market are borrowing from BPS, BPS is functioning as an off-budget financing mechanism (with contingent fiscal risk). Where public enterprises borrow from BPS at below market rates, BPS is being used to provide an off-budget subsidy – although BPS also argues that servicing public enterprises provides it with lending opportunities of relatively high quality and helps avoid taking on further credit risk from lending to private sector corporate borrowers.
- Second, BPS is providing social payments services (pensions, disability and unemployment payments) to the government and the bank estimates that it incurs a substantial annual loss (estimated by BPS at EUR 11.7 million per annum) due to excessive transaction charges levied by the Post Office compensated for by only a nominal fee paid by the social funds for the service. As a result, BPS subsidizes the cost of distribution of the payments and the Post Office operating costs. Attempts by BPS to place the social payments business on at least a break-even basis at have been repeatedly blocked, again highlighting the impact of political control on the bank's operations.

*Government Objectives for BPS*

**13. The government's reform strategy for BPS is expressed in a government conclusion - which is binding on BPS - approved on 15 August 2016**. The government's program for reform of BPS centers on three key areas: 1) Reorientation of the business strategy; 2) Governance and Risk Management reform; and 3) Operational restructuring. The conclusion calls for the bank to prepare a three-year business plan aligned with these three areas with the assistance of an independent external firm and to have the plan approved by the Shareholder Assembly.

**14.** ***Reorientation of Business Strategy:*** The government conclusion envisages that the bank will minimize contingent fiscal risks mainly by a) adopting a retail business strategy, which leverages the bank's retail presence and supports sustainable long-term profitability without imprudent credit risks; and, b) limiting the use of the bank as an off-budget financing mechanism for public enterprises; and, c) redefining the bank's business relationship with PTT to eliminate the subsidization of Post Office operations using fees paid by BPS on payments transactions. The business strategy entails the following elements:

1) Focus on retail lending and services including households, entrepreneurs, micro and small enterprises
2) Run-down of large (>EUR 8.8 million revenues) private sector credit exposures and reduction of NPLs
3) Caps on the size of new credit exposures to private sector enterprises
4) Caps on lending to public sector enterprises and restricted to enterprises where international financial institutions are either participating or providing risk analysis
5) Redefinition of the terms of business with PTT to place it on at least a break-even basis, eliminating subsidization of PTT by BPS

**15.** ***Corporate Governance and Risk Management Reform:*** The expansion of the corporate lending portfolio was undertaken without first putting in place either adequate human capital or processes for credit appraisal and risk management. These deficiencies together represented a significant corporate governance failure on the part of the then BoD, which failed to ensure the prudent management of the bank. The government has implemented measures to improve BPS' governance and the conclusion requires the following actions:

1) Appointment of four independent directors to the BoD with backgrounds in banking and finance. Three of these members were nominated by the MoF and one by the DIA;
2) Reorganization of the BoD to form a sub-committee with responsibility for audit and risk in line with NBS regulations;
3) Expansion of the Executive Board to five members, all with defined responsibilities;
4) Appointment of a Chief Risk Officer (CRO) as a member of the Executive Board reporting directly to the BoD and who can be terminated only by the BoD;
5) Creation of an independent Risk Management Department (RMD) with veto rights over all credit decisions;
6) Adoption and implementation of comprehensive risk management policies and procedures granting veto rights over all credit decisions to the RMD;
7) Adherence to NBS provisioning guidelines for the application of IAS 39;
8) Staffing of all risk management functions with an adequate number of appropriately qualified professionals;
9) Regular reporting of the BoD and Executive Board to the MoF on implementation of the conclusion.

**16. As a result of the conclusion, in November 2016 the composition of the management Executive Board was expanded and restructured in line with international practice**: two members (out of three) of the Executive Board were replaced and, as a result of an open tender, four new members were appointed (three of whom have strong professional experience in the functional area they are responsible for). All members of the Executive Board now have specific responsibilities for functional areas of the bank, including a Chief Executive Officer (CEO), Chief Financial Officer (CFO), Chief Risk Officer (CRO), Chief Market Officer (CMO - in charge of the bank's front office), and Chief Operating Officer (COO). This restructuring and definition of responsibilities was designed to address the weakness of the previous Executive Board that had collective responsibility for all bank operations, rather than defined responsibilities for which an individual could be held accountable. In 2018, governance will be further strengthened by the implementation of performance-based contracts for the members of the Executive Board, explicitly linking part of their compensation to the achievement of specific Key Performance Indicators (KPIs) identified in the bank's 2018-20 Business Plan. The BoD has also passed a decision on the separation of all risk management functions into a new Risk Management Department, with the CRO also being given a veto over all credit decisions (including at the Executive Board level). In 2018 the organizational separation of the RMD from all front office units will be completed and the responsibilities of each RMD sub-unit and employee will be fully defined; the bank will complete hiring of appropriately skilled and experienced staff for the RMD; the BoD will adopt comprehensive risk management policies and procedures; and, RMD staff will receive training (supported by TA financed by the proposed operation).

**17.** ***Operational Restructuring:*** The government conclusion highlights the need to restructure the operations of the bank in order to support the implementation of the new strategy and ensure the viability of the bank. This transformation necessitates a complete restructuring of the bank's business processes, organization, and modernization of its IT infrastructure. While the bank has in place a large and expanding network of offices, these offices have been focused on deposit gathering and providing a very limited range of financial services such as payments and retail overdraft facilities. The bank also needs to restructure, expand, and upgrade its workforce by providing training to create a sales-focused culture in the front office. Compensation levels in the bank will be raised to market levels to allow it to recruit, incentivize, and retain qualified employees. The reform also requires the bank to purchase a new core banking system and third party applications designed to support a mass-market strategy. The bank's aged IT system (dating from the late 1980's) both fails to provide a platform for new products and poses significant operational risks and costs due to the amount of paper processing still required (175 people – almost 10 percent of the bank's staff – are employed in document management and a further 80 people are employed in the IT Department). An upgraded IT system is necessary to enable the bank to deliver standardized financial products to the mass retail market. Replacing the IT system will require a significant amount of time and is likely to take three to four years to implement. The government conclusion requires the following (all to be supported by technical assistance financed by the proposed operation):

1) Reorganization of BPS to meet the needs of it's the new strategy;
2) Systematization of working positions;
3) Implementation of a market-based compensation scheme for BPS employees to allow it to hire, retain, and incentivize qualified staff;
4) Replacement of current IT system with a modern core banking system and business process applications aligned with the bank's retail and MSE-focused strategy.

**Focus Area 2 – Development Finance and other State-Owned Financial Institutions Reform**

*Background and Rationale*

**18. There are several other elements of the government's SOFI reform program that are supported by this operation:** a) addressing the identified problems in the DF and AOFI and developing a strategy for development finance; b) improving the oversight of SOFIs by the MoF and its capacity to implement the strategy on state-owned banks; and c) improving the recovery of bad assets from state owned financial institutions.

*a) Development Fund, AOFI and Strategy for Development Finance*

**19. The Development Fund is the key government institutions for financing enterprises in Serbia.** Its mandate is to provide support to entrepreneurs, encourage economic and regional development, improve competitiveness of the domestic economy, and stimulate employment. The DF provides various types of loans and guarantees to the corporate sector, including for start-ups.

**20. The Serbian Export Credit and Insurance Agency (AOFI) provides export credit insurance and financing to Serbian export-oriented companies.** This includes short-term lending at favorable conditions, factoring, insurance of foreign receivables, and issuance of guarantees for local companies, including SMEs.

**21. Independent diagnostic studies of the DF and AOFI revealed considerable weaknesses of the current institutional framework for development finance.** The diagnostic study for the DF has been completed and revealed very high NPLs. The results also showed challenges for AOFI with high NPLs. Based on the results of these studies, the government adopted conclusions on the DF and AOFI mandating them to address the challenges identified. Both institutions are required to report to the government on the actions taken in accordance with the criteria and there will be close monitoring of the implementation of the conclusions. The next step for the institutions is to take decisions consistent with the quantitative and qualitative requirements of the conclusions.

22. **The government has launched a process of reviewing the framework for providing development finance in Serbia.** The potential of a well-structured and properly governed development finance framework is significant. There is already a large volume of state-supported financing for the enterprise sector (e.g. support through the budget, financing from the resources of the existing DFIs, various credit lines, funds from the EC, etc.), and in the future, this funding will increase. This is due to increasing availability of EU funds, and ability to crowd-in long-term funding from the market and multilateral institutions like the World Bank Group, EIB Group, EBRD, KFW, and the Council of Europe Development Bank. As development finance can play an important role in supporting economic growth and catching up with the more successful and competitive regions of the EU, the government decided to review the framework of development finance. This would also resonate well with the requirement to develop an industrial strategy as the closing benchmark for Chapter 20 (Industrial Policy and Entrepreneurship).

23. **Development finance plays an important role as a public policy instrument that supports government's economic and industrial policies.** It facilitates the growth and competitiveness of companies and ultimately the economy under the strategic direction of the government. Development finance is widely used to support financing of SMEs, exporters, or start-ups, in a range of sectors – e.g., agriculture, wholesale/retail, accommodation and food, manufacturing, transport, construction – and can also encourage investments in priority areas such as energy efficiency or have a regional focus. In doing so, a wide range of financing solutions is possible – loans, guarantees, equity finance, venture capital investments, export credit guarantees and export finance.

24. **To establish the role that development finance could have in Serbia, a development finance or access to finance strategy will be developed.** A working group will be established to provide the government with options for providing development finance in Serbia. The working group will look at development finance in a more comprehensive manner, going beyond the existing institutions, and considering international best practice related to institutional structure, market failures that need to be addressed, principles of corporate governance, adequate supervision, and others. The goal is to propose what kind of changes are needed to maximize the potential of development finance without putting too much burden on the budget itself. The mandate of the working group should be wide and also include consultations with representatives of the business community. It should not be a large group – on the contrary, there should be around six people, consisting of higher level officials from MoE, MoF, NBS, and a few carefully chosen stakeholders that are ready to assist. The strategy also needs to be in line with best practices across the EU given Serbia's medium-term goal to enter the EU and make use of EU funds in the future.

25. **A better understanding of market failures that should be addressed by development finance is needed to properly inform the strategy.** Reported market failures include: (i) credit rationing reflected in both cost and collateral requirements due to banks' high transaction costs for identifying viable investment projects (e.g. in the SME sector or innovative, young and potential growth companies), (ii) underinvestment in areas such as innovation financing, infrastructure financing, and environmental projects, and (iii) lack of financial instruments geared toward microfinance, long-term finance, guarantees, and mezzanine and equity financing. A market study will be needed to better understand these reported market failures and identify whether there should be role for development finance in addressing them.

26. **Overall, the reforms related to development finance are in early stages of discussion.** Currently, the supported reforms in the area of development finance are focused on developing a forward-

looking strategy. The process and the completion of the strategy will define the financial sector reforms going forward. There is no predetermined outcome regarding the development finance strategy and the possible changes government would need to make to yield better results and make the overall framework more efficient. However, supporting this area will enable the Bank to be part of the decision-making process in developing a detailed blueprint on the role and functions that would be suitable for the Serbian market. At a later stage, once the government adopts a comprehensive and suitable strategy on the role of development finance, possible further support may be envisaged to deepen the engagement on this topic.

*b) Resolution of NPLs of SOFIs*

**27. There is a large volume of bad assets from SOFIs that are managed within individual open SOFIs and by the DIA on two legal bases:** (i) for banks under resolution and (ii) for bad assets owned by the RoS as its legally recognized agent. Through the collaborative approach developed through the NPL Resolution Strategy and the pilot projects, the level of NPLs decreased significantly both in nominal as well as in relative terms.

**28. The first pilot project included three large corporate groups at various stages of restructuring, rehabilitation or liquidation under the Bankruptcy Law and has proven effective and useful in accelerating and coordinating recovery efforts on claims of State Creditors.** Given the status of many of the companies in the business groups, it was clear from the outset that outcomes would be limited, however, the outcomes were much better than might otherwise have been achieved. Recoveries would have been higher and more businesses might have been preserved had the collaborative approach started earlier.

**29. In order to achieve a higher collection rate of NPLs from debtors and to improve the efficiency and effectiveness of resolution, State Creditors signed a Memorandum of Cooperation (Memorandum).**[17] The Memorandum became final in February 2017 and envisages the establishment of a working group consisting of representatives of institutions – signatories, whose role is to make the principles of cooperation operational, draw up an action plan, take positions, make recommendations and identify obstacles that need to be removed to facilitate cooperation. The Memorandum also envisages the establishment of coordination committees for specific debtors or a group of debtors. Additionally, the guidelines regulate the means of exchanging information about the procedures related to the settlement of problematic debts, as well as the manner of adoption of action plans containing relevant time frames for activities involving state creditors.

**30. With the support of the World Bank, the MoF has initiated a second pilot project that includes several additional corporate groups that were selected using the following criteria**: 1) at least one debtor in the group is active; 2) size of the aggregate exposure of State Creditors; 3) size and quality of collateral of State Creditors; and 4) the extent of concentration of State Creditors in a business group. Based on the identification of exposures eligible for disposal, the five specific borrower groups were selected for potential disposal. However, a more detailed assessment resulted in only four groups being eligible for the disposal. The total loans exposure of the selected four group of debtors toward one or more State Creditors amounts to EUR 145.6 million.

**31. The next steps in the process of the disposal of the exposures related to the second pilot will**

[17] The Memorandum of Cooperation came into force in February 2017, and was preceded by the adopted Government Conclusion 05 No. 42-215/2017 of 24 January 2017, which gave consent to the draft text of this Memorandum with the associated appendix.

**require several formal decisions to be reached by the relevant stakeholders**. For some stakeholders, including the DIA, this may require adoption or amendments of internal acts. Before or in parallel with these efforts, the DIA and other stakeholders have prepared the documentation and data for disposal based on the guidance prepared by the advisor so as to be ready for implementation once the formal decision has been made. These activities include updating appraisals of collateral, needed for assessing the proceeds from the disposal and leveraging expectations from the process. The advisor has developed a detailed work plan which defines key steps, roles and responsibilities in reaching the decision on disposal as well as for the implementation of NPL disposal. The advisor will conduct the new valuation of collateral for the groups, as well as other activities related to the due diligence, the preparation of data tapes and proposals for the optimal way of disposition of debtor's claims.

32. **Following the successful pilot projects, the next phase in NPL resolution will consist of a "prime bucket"** of the best claims of State Creditors against 18 debtors' groups (which comprise of 144 debtors) with an aggregate portfolio value of approximately EUR 830 million, to be structured in a manner that would be of interest to potential investors. The assessment of suitability for sale and the optimal sales structure will require an additional segmentation and strategic analysis of corporate groups including the possibility to include smaller exposures, i.e. exposures below EUR 20 million, that might also be eligible for sale.

33. **To improve asset management of financial institutions in bankruptcy and the estate, and claims that the DIA administers on behalf of and for the account of the Republic of Serbia, the DIA in cooperation with the advisor has prepared the Strategic Plan.** The strategy covering the period from 2017 to 2020 was adopted by the board of the DIA in April 2017. The Strategy defines the main objectives of the Agency in the management of NPLs and assets: 1) efficient and effective management of problematic loans and assets; 2) maximization of settlement of creditors of financial institutions in bankruptcy, including the state; and 3) a regular distribution of realized assets which make up the bankruptcy mass, based on the annual operational plans. To improve asset management, the Strategic Plan envisages a number of organizational changes including consolidation of the databases managed by the DIA, activities related to the recognition and value assessment of claims, and improvement and development of new options for debt collection. The plan also envisages that the DIA should examine the possibilities of alternative approaches to acceleration and completion of the bankruptcy proceedings of banks and offers models that would resolve existing problems and enable the final settlement of creditors.

34. **Based on the notable results achieved during the implementation of the NPL Resolution Strategy, an updated NPL Resolution Strategy will envisage the adoption of separate Action Plan related to state-owned NPLs.** The updated NPL Resolution Strategy will define an Action Plan for state-owned NPL resolution, which will also be cognizant of the DIA's Non-Performing Loan and Asset Management Strategic Plan. A separate working group (consisting of State Creditors and MoF representatives) established by the government will be in charge of implementation of the adopted Action Plan for state-owned NPL resolution. The working group will rely on the Memorandum of Cooperation concluded by the State Creditors, which contains mutually agreed elements related to the coordination of efforts towards resolving NPLs from common debtors. As stipulated, the Coordination Board, once established, shall define and negotiate the adoption of the Strategy in accordance with which it will coordinate with other creditors' representatives, taking into account the overall goal to lower the number of state-owned NPLs.

*c) Oversight of SOFIs and Implementation of Strategy on State-Owned Banks*

**35. There are significant gaps in the corporate governance of SOFI as well as the ownership and oversight function.** There are deficiencies in the ownership and oversight framework for SOFIs overall, as well as significant gaps in the oversight of specific institutions (e.g., DF and AOFI). There is also no corporate governance framework for SOFI's. The government has recognized this as a deficiency and has incorporated requirements for strengthening corporate governance through an open and transparent process in its updated strategy on state owned banks. There was no clear entity responsible for performing the oversight functions for all SOFIs until the creation of the MoFFS. The project will support this unit in the MoF to carry out its legal mandate for overseeing SOFIs (e.g., TA is provided to the MoF for developing and implementing a regular oversight process for SOFIs and assisting the MoF in implementing the SOFI strategy).

***Project Design***

**Component 1: Support the Reform of State Owned Financial Institutions (EUR 27,969,750)**

**36. This component will reimburse EEPs based on the achievement of a series of DLIs/DLRs in the two reform areas supported by the project.** Disbursements require achievement of DLIs/DLRs in the two areas described above. Each DLI/DLR is given a EUR value. Time frames for the achievement of DLIs/DLRs have been developed for the duration of the project, but are indicative and disbursements can occur at any time when the DLIs/DLRs have been achieved and the EEPs can be verified. Exceptions are DLRs 1.3 and 1.5 which are time-bound, but scalable and can be disbursed upon if they are achieved after the target date. DLIs/DLRs with indicative years are presented in Tables 4-7 and DLIs/DLRs with associated EUR values in Table 9. The DLIs/DLRs are summarized in the following paragraphs.

***Focus Area 1: BPS Restructuring***

**Disbursement-linked Indicator 1: Restructure Banka Postanska Stedionica AD Beograd**

Disbursement-linked Result 1.1 – Business Plan

**37.** This DLR supports the adoption (retroactive) of the 2018-2020 business plan for BPS in line with the qualitative and quantitative targets consistent with the quantitative and qualitative requirements of the government's conclusion. Implementation of the business plan will be supported by TA and investments in IT co-financed by the proposed project and a legal covenant will be included on the hiring of external consultants for implementation of 2018-2020 business plan in the year 2018.

Disbursement-linked Result 1.2 – Agreement between BPS and PTT

**38.** This DLR supports the signing of a comprehensive agreement between BPS and PTT on the business model for joint operations that places BPS business conducted though PTT offices on a mutually beneficial financial footing by fairly allocating costs and revenues and allowing both institutions to benefit from the expansion of BPS financial services through the PTT post office network, in line with the business partnership models used by postal banks and postal services in other countries.

Disbursement-linked Result 1.3 – Phasing out corporate lending and lending to SOEs

**39.** This DLR supports achievement of time-bound targets for phasing out corporate lending and cap on lending to SOEs in line with the government's conclusion and BPS' approved business plan.

Disbursement-linked Result 1.4 – Compliance with prudential ratios

**40.** This DLR supports the achievement of the government's objective that BPS should become fully self-sustaining and compete on a level playing field with commercial banks by requiring that the bank maintain full compliance with key NBS prudential ratios (capital adequacy and liquidity ratios).

Disbursement-linked Result 1.5 – NPL reduction

**41.** This DLR supports the implementation of strengthened risk management processes and completion of the clean-up of the historical corporate NPL portfolio by establishing a maximum level of corporate NPLs to be achieved by the conclusion of the program.

**Table 4: DLRs related to BPS Restructuring**

| Retroactive | 2018 | 2019 | 2020 | 2021 |
|---|---|---|---|---|
| DLR 1.1 BPS has adopted a business plan for the calendar years 2018-2020, consistent with the quantitative and qualitative requirements of the BPS Conclusion | | DLR 1.2 An agreement detailing the business model for joint operations between BPS and PTT has been executed | DLR 1.3 The gross amount of BPS Performing Credit Exposures to medium and large private sector enterprises has been reduced by not less than 60% by December 31, 2020, compared to December 31, 2016; and (ii) the limit on BPS lending to SOEs, as set forth in the BPS Conclusion, has been complied with by December 31, 2020 | DLR 1.4 BPS is in compliance with the prudential ratios set forth in Selected NBS Decisions, by December 31, 2020<br><br>DLR 1.5 BPS gross NPLs have been reduced by not less than 50% by December 31, 2021, compared to December 31, 2016 |

***Focus Area 2 – Development Finance and other State-Owned Financial Institutions Reform***

**Disbursement-linked Indicator 2: Complete Reforms and Develop Strategy on Development Finance**

Disbursement-linked Results 2.1 and 2.2 – Development Fund and AOFI

**42.** These DLRs support the completion of diagnostic studies for the Development Fund and AOFI (retroactive) and the approval of Decisions consistent with the quantitative and qualitative requirements of the conclusions. Those Decisions should also propose measures to prevent further deterioration in asset quality, and identify solutions to resolve impaired assets.

Disbursement-linked Result 2.3 – Development Finance

**43.** This DLR supports the development and adoption of a strategy on Development Finance, which will incorporate the lessons learned from the experience of the DF and AOFI and World Bank recommendations. Most importantly it will provide a forward-looking approach to development finance, including the identification of an effective institutional model to address the identified market failures.

**Table 5: DLRs related to Development Finance**

| Retroactive | 2018 | 2019 | 2020 | 2021 |
|---|---|---|---|---|
| DLR 2.1 A diagnostic study for the Development Fund and AOFI have been completed | DLR 2.2 The supervisory boards of the Development Fund and AOFI have each adopted Decisions consistent with the quantitative and qualitative requirements of the Development Fund Conclusion and AOFI Conclusion, respectively | DLR 2.3 The Borrower has adopted a strategy for Development Finance | | |

**Disbursement-linked Indicator 3: Implement NPL Resolution Strategy and State-Owned Banks Strategy**

Disbursement-linked Results 3.1 and 3.2 – NPL Tender

**44.** These DLRs will support the tender of the first group of NPLs held by SOFIs as well as the "prime bucket", based on an updated NPL Resolution Strategy and strategy for state-owned NPLs, which will be developed with support provided under the TA component. There are two phases that should lead to the issuance of the tender of the first group of SOFIs' non-performing loans: 1) activities related to defining the sale strategy by relevant stakeholders; and 2) pre-marketing activities related to preparation and execution of the sale. The second phase includes, among others, activities related to the preparation and release of teasers, obtaining expressions of interest, as well as finalization of data remediation and preparation of data for the data room.

**45.** The remaining portfolio is recommended for additional strategic and segmentation analysis. The outcome of this process should result in the issuance of the tender for the 'prime' bucket. The guidance for the process will be defined more specifically in the action plan for the resolution of SOFI's non-performing loans.

**Table 6: DLRs related to NPL Resolution**

| Retroactive | 2018 | 2019 | 2020 | 2021 |
|---|---|---|---|---|
| | | DLR 3.1 A tender for the sale of SOFI's NPLs, in an approximate amount of EUR 145,600,000, has been issued by the Borrower | A tender for the sale of the Prime Bucket of SOFI's NPLs based on the NPL Resolution Strategy, in an approximate amount of EUR 832,300,000, has been issued by the Borrower | |

<u>Disbursement-linked Result 3.3 – Other State-Owned Bank Reform</u>

**46.** This DLR supports the preparation and implementation of a government conclusion on corporate governance for SOFIs. This is in line with the government's strategy for state-owned banks. The conclusion should be acceptable to the World Bank and incorporate relevant international best practice as will be laid out in the verification protocol to be included in the POM.

**Table 7: DLRs related to other State-Owned Bank Reform**

| Retroactive | 2018 | 2019 | 2020 | 2021 |
|---|---|---|---|---|
| | | | | DLR 3.3 (i) The Borrower has adopted a Conclusion on corporate governance for State-Owned Banks by December 31, 2019; and (ii) any appointment of a board member of State-Owned Banks after the Conclusion becomes effective until December 31, 2021, has been done in accordance with the requirements of said Conclusion |

<u>**Component 2: Strengthen Institutional Capacity (EUR 12,030,000)**</u>

**47. For the first reform area, this component will provide TA and the purchase of needed goods to support the implementation of key activities identified in BPS's 2018-20 business plan.** The following areas, where support is likely to be provided, have been initially identified:

- Support for the design and implementation of a bank-wide compensation system incorporating: (a) market-competitive salaries; and, (b) incentive compensation based on KPI's aligned to each

position in the bank;
- Specialized training for staff of the Risk Management Department;
- Design and/or purchase of risk management applications software adapted to the high volume/low value retail and micro and small business focus of the bank's lending activity;
- Sales and cross-selling training for front office staff to improve employee productivity;
- Support for the design of new products (e.g. agricultural energy efficiency lending) and required sales application software;
- Product-specific sales training for front office staff; and,
- Purchase of a new core banking system (software and hardware for main system and back-up system), applications, and migration, installation support, maintenance, and training services.

The CFU, with World Bank procurement support and specialist expertise in areas such as IT procurement, will procure all goods and services provided to BPS.

48. **For the second reform area, support will be provided to the MoF for achieving the DLIs/DLRs through TA.** The component will finance consulting services needed to assist in the implementation of the strategy for development finance, consultants for the MoF to improve the oversight of SOFIs, including those outside of the scope of the results-based component (e.g. Dunav), and technical assistance for the resolution of NPLs of SOFIs. The MoFFS staff will be complemented with senior and junior consultants specialized in the areas supported by the project, including but not limited to legal experts, advisers for restructuring and privatization, and analysts for monitoring the different types of SOFIs. Table 8 provides a breakdown of the expected allocation of funds under Component 2 based on the initial procurement plan.

**Table 8: Allocation of Funds for Component 2**

| ***Focus Area 1 – BPS Restructuring*** | |
|---|---|
| Consulting services for implementation of 3-year business plan | EUR 1,523,800 |
| Core banking system, hardware, and IT procurement support | EUR 5,076,660 |
| **Total Focus Area 1** | **EUR 6,600,460** |

| ***Focus Area 2 – Development Finance and other State-Owned Financial Institutions Reform*** | |
|---|---|
| Oversight of SOFIs by MoF | EUR 2,021,040 |
| Development finance reforms and strategy | EUR 593,480 |
| Privatization and implementation of strategy for state-owned banks | EUR 1,259,140 |
| Resolution of state-owned NPLs | EUR 1,211,020 |
| **Total Focus Area 2** | **EUR 5,084,680** |

| | |
|---|---|
| **Project Implementation Support** | **EUR 344,860** |

**Table 9: Disbursement Linked Indicators and Results for the Serbia State Owned Financial Institutions Project**

| *DLIs* | *Disbursement Linked Results* | *Amount (EUR)* |
|---|---|---|
| **DLI 1. Restructure Banka Postanska Stedionica AD Beograd** | DLR 1.1 BPS has adopted a business plan for the calendar years 2018-2020, consistent with the quantitative and qualitative requirements of the BPS Conclusion | 802,000 |
| | DLR 1.2 An agreement detailing the business model for joint operations between BPS and PTT has been executed | 3,107,750 |
| | DLR 1.3 The gross amount of BPS Performing Credit Exposures to medium and large private sector enterprises has been reduced by not less than 60% by December 31, 2020, compared to December 31, 2016; and (ii) the limit on BPS lending to SOEs, as set forth in the BPS Conclusion, has been complied with by December 31, 2020 | 4,010,000 |
| | DLR 1.4 BPS is in compliance with the prudential ratios set forth in Selected NBS Decisions, by December 31, 2020 | 4,010,000 |
| | DLR 1.5 BPS gross NPLs have been reduced by not less than 50% by December 31, 2021, compared to December 31, 2016 | 4,010,000 |
| **DLI 2. Complete Reforms and Develop Strategy on Development Finance** | DLR 2.1 A diagnostic study for the Development Fund and AOFI have been completed | 802,000 |
| | DLR 2.2 The supervisory boards of the Development Fund and AOFI have each adopted Decisions consistent with the quantitative and qualitative requirements of the Development Fund Conclusion and AOFI Conclusion, respectively | 1,604,000 |
| | DLR 2.3 The Borrower has adopted a strategy for Development Finance | 2,406,000 |
| **DLI 3. Implement NPL Resolution Strategy and State-Owned Banks Strategy** | DLR 3.1 A tender for the sale of SOFIs' NPLs, in an approximate amount of EUR 145,600,000, has been issued by the Borrower | 2,406,000 |
| | DLR 3.2 A tender for the sale of the Prime Bucket of SOFI's NPLs based on the NPL Resolution Strategy, in an approximate amount of EUR 832,300,000, has been issued by the Borrower | 2,406,000 |
| | DLR 3.3 (i) The Borrower has adopted a Conclusion on corporate governance for State-Owned Banks by December 31, 2019; and (ii) any appointment of a board member of State-Owned Banks after the Conclusion becomes effective until December 31, 2021, has been done in accordance with the requirements of said Conclusion | 2,406,000 |
| **Total** | | **27,969,750** |

## ANNEX 2: IMPLEMENTATION ARRANGEMENTS

**COUNTRY: SERBIA**
State-Owned Financial Institutions Strengthening Project

### Project Institutional and Implementation Arrangements

1. **The Central Fiduciary Unit within the MoF will be in charge of fiduciary responsibilities for the project, while the MoF will be the primary implementing entity and responsible for all technical aspects of implementation.** The CFU has been established in October 2017 and will have overall financial and procurement responsibilities, including providing a consolidated report on the EEPs. Costs will be shared proportionally with other projects which will be managed by the CFU, and the project's funds will only support the CFU consultants who specifically support this project. In addition, the Ministry of Finance unit in charge of overseeing the financial sector, the MoFFS, will be in charge of overseeing and executing all of the project activities, including M&E and project progress reporting, and project implementation would rely on current resources in the unit, with the additional support of consultants that will be established under the TA component of the project The implementation arrangements will place an emphasis on strengthening the MoFFS's capacity to oversee SOFIs through monitoring the DLIs/DLRs and other aspects of the government's SOFIs strategy.

2. **A project operation manual (POM)** describing the objectives, targets, DLR verification protocols, and financial management and monitoring arrangements will be completed before effectiveness.

### Financial Management and Disbursements

#### Risk Analysis

3. The overall financial management risk for the Project is substantial before mitigation measures, while the financial management residual risk is rated moderate with adequate agreed mitigation measures. The combined fiduciary risk for the project is assessed to be substantial.

#### Implementing Entity and Staffing

4. The CFU has been established and adequately staffed, including the financial management function. The unit has been established on October 24, 2017, and, at the moment, it includes three employees, namely the CFU Director, Financial Management Specialist and Procurement Specialist. Capacity of the unit will be monitored with new projects starting implementation and the number of staff will be accordingly increased to match the needs. The CFU will be in charge of fiduciary (financial management and procurement) responsibilities for the project, while the MoF will be responsible for the technical aspects of implementation. The CFU will be in charge of collecting financial information on EEPs from the MoF and MoE quarterly reports and presenting those in the project Interim Unaudited Financial Reports (IFRs). Component 2 will relate to technical assistance and traditional implementation arrangements will apply. This implies that a project designated account will be opened for the project and the funds will be withdrawn to the account through advances, while the account will be replenished based on SOEs. Direct payment will be another disbursement method allowed for Component 2 for payments above the threshold determined in the DFIL All responsibilities will be described in the staff's Terms of Reference. All controls and procedures, including split of responsibilities for the project, will be described in the POM to be prepared by project effectiveness.

**Planning and Budgeting**

**5.** The project will rely on the country's budgeting system for Component 1. The system is assessed to be sufficiently credible by observing the process and procedures, as well as deviations of execution to originally approved budget. EEPs for the project will be salaries, and it is estimated that the associated risk of inaccurate budgeting or deviations in executions is low for this type of expenditure.

**6.** The PIU (MoFFS) and the CFU, both within the MoF, will prepare plans and budgets with regard to Component 2. Current budgeting capacity in the MoF is appropriate and it will be ensured, between the existing procedures in the MoF and the Bank's guidance, that appropriate capacity for budgeting is instituted within implementing units. The POM will provide further guidance with regard to the planning and budgeting process and responsibilities.

**Accounting and Financial Reporting**

**7.** The CFU will acquire an acceptable financial management software and technical specification for the software has been prepared and the acquisition process initiated, which will be used to maintain accounting records for projects in its portfolio, including this project, and prepare financial reports. The software should include features to enable appropriate analytical accounting information in a user-friendly manner and generate financial reports in the agreed format automatically. It would be highly beneficial if the software provided management reports which would serve as an important source of information for the project management and enable informed decision making.

**8.** The CFU will prepare separate semi-annual interim financial reports (IFRs) for Component 1 and Component 2 and deliver them to the Bank within 45 days after the end of the reporting period. The information for the IFR for Component 1 will be sourced from quarterly budget execution reports of the MoF and the MoE, while the IFR for Component 2 will be based on accounting records for the TA maintained in the CFU software. Delivery of IFRs is a covenant in project legal documents.

**9.** Accounting for the project will be on cash basis, and in compliance with cash-basis IPSAS.

**Internal Controls**

**10.** Financial management arrangements for Component 1 will rely on the country systems, including internal controls. Since the Component 1 will finance salaries within the MoF and MoE, the payroll system within the government's institutions has been in the center of the financial management assessment. The above institutions are included in the centralized payroll system. The principal authority in charge of centralized payroll processing is the Treasury Administration of the MoF, whose statutory obligations in this regard are set out in amendments to the Law on Budget System, from 2013. The centralized payroll system was assessed under the Public Expenditures and Financial Accountability (PEFA) assessment and it is judged to be reliable.

**11.** Internal controls for Component 2 will be described in detail in the POM and application of controls and procedures will be confirmed by the Bank's on-site supervision and the independent external audit.

**12.** Key controls should include:

a. reconciliation of the Bank's disbursement summaries with accounting records on monthly basis by the FM officer;
b. reconciliation of bank statements with accounting records on monthly basis by the FM officer;

c. reconciliation of SoEs with accounting records at the time of each withdrawal by the FM officer;
d. segregation of duties as no one person has responsibility for all phases of transaction;
e. specific staff authorized for signing and approving of transactions;
f. transactions are properly documented.

**13.** The payment cycle should be adequately controlled. Received invoices should be verified against the contract and delivered goods/services by technical staff in the MoFFS. After signing off by the technical staff, the financial management staff of the CFU checks the invoiced amount against the contract ceiling. Invoices verified and signed off in such manner are forwarded for payment. A payment order signed by the authorized signatories (CFU Director, MoF Senior Official) accompanies the invoice. Original and complete documentation relating to the above process should be available.

**External Audit**

**14.** Separate annual project financial statements for Component 1 Component 2 will be audited by a private audit firm acceptable to the Bank. The audit will be delivered to the Bank within six months after the end of the audited period. The audit will be based on ToRs for financial audit, while responsibility to collect relevant documentation for achievement of DLIs/DLRs will rest with the MoF. Independent verification of achievement of DLIs/DLRs will be conducted by external consultants to be hired under the project. The consultants will review the credibility and accuracy of the supporting documentation provided by the MoF.

**15.** The audit will be conducted by a firm on the list of eligible firms to audit WB supported projects. The audit will be conducted in line with International Standards on Auditing (ISA). The annual audit will be due six months after the end of the audit period and it will be a covenant in legal documents for the project.

**Flow of Funds**

**16.** There will be no designated account opened for the results-based financing part (Component 1) and the funds are expected to flow to a foreign currency account within the NBS which the government indicates. The funds will be disbursed based on (i) EEPs and (ii) verification of achievement of DLRs. The method of disbursement is envisaged to be reimbursement and the funds will flow to a EUR account. SOEs will be the basis for disbursement. The first withdrawal will be based on achievement of DLRs and retroactive financing of EEPs incurred prior to the signing/and reimbursement of EEPs between signing and effectiveness. The component will disburse at any point when the following conditions are fulfilled (i) EEPs as evidenced by the SOEs in the amount equal or higher to the amount attributed to achieved DLRs, and (ii) verification and confirmation of achievement of DLRs. If the DLRs have not been met in full, partial achievement of DLR 1.3 and 1.5 may result in partial disbursement, with proportional disbursement reflecting the percentage achieved of the respective target. Disbursements withheld due to non-achievement of DLRs 1.3 and 1.5 in a given year may be released in subsequent years once the DLR is achieved, or cancelled by the Bank. Figure 1 shows the flow of funds for Component 1.

**17.** The funds for the TA (Component 2) will flow through a foreign currency designated account. The Designated Account (DA) will be opened in the National Bank of Serbia and used solely for inflows and outflows related to Component 2 of the project. For local currency payments, the funds will be converted to a sub-account within the STA opened solely for the purpose of using project funds for payments in local currency. The disbursement method used for this part will be primarily advances, with methods of direct payment and reimbursement being also allowed as alternatives. It will be a EURO account. Disbursement will follow a traditional model and will be based on SOEs. Figure 2 shows the flow of funds for Component 2.

**Figure 1. Flow of Funds – Component 1**

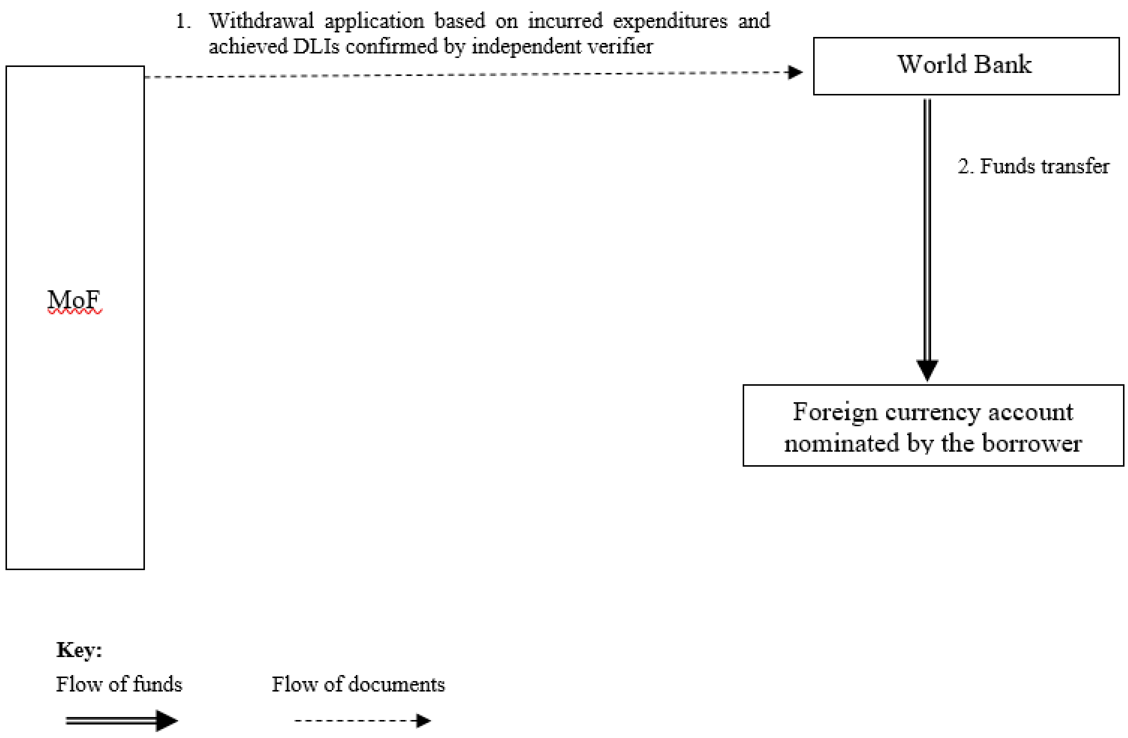
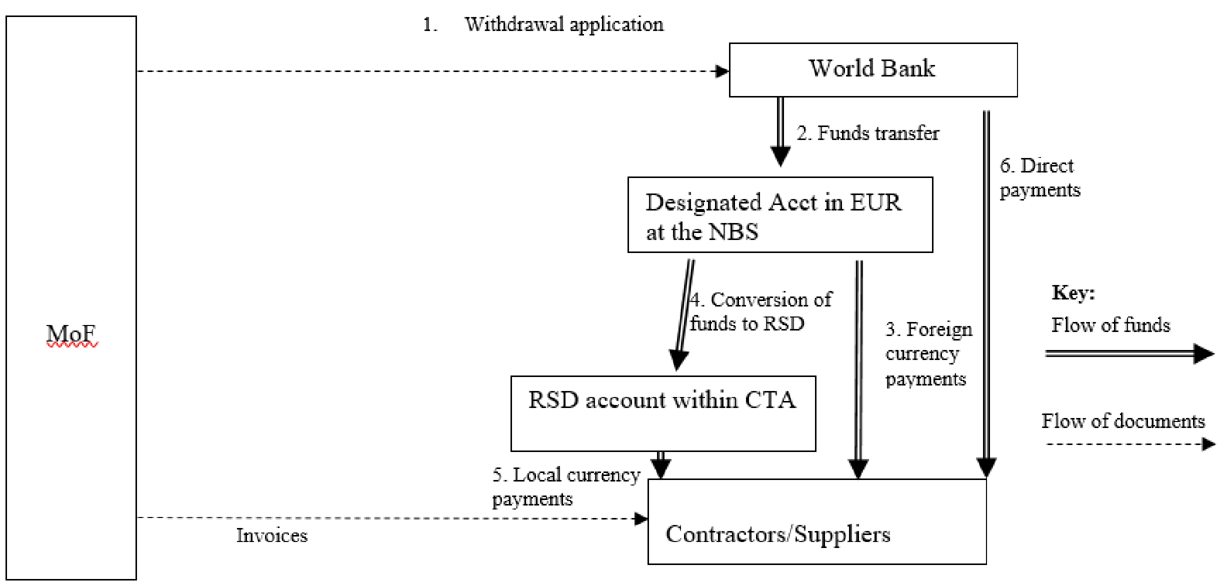



**Figure 2. Flow of Funds – Component 2**



**18.** Under Component 1, payments for the reimbursement of EEPs will be made when the agreed DLRs are met and certification of the agreed statement of EEPs are submitted to the WB. Achievement of the DLRs will be confirmed to the WB according to the verification protocols established for each DLR and included in the POM. Up to 25 percent of the total amount for the component can be advanced to the borrower, which will be converted to disbursements based on subsequently achieved DLIs, which will enable new advances up to the same level.

**19.** Eligible Expenditure Programs: The EEPs under the project will include selected salaries for the Ministry of Finance and Ministry of Economy, as both are responsible for oversight of selected SOFIs as well as access to finance issues and the MoF is managing contingent fiscal liabilities, which SOFIs contribute to. These will be specified in the POM.

**20.** Retroactive Financing: An aggregate amount up to EUR7.5 million may be made for retroactive payments based on EEPs during the 12 months before loan signing. Retroactive financing is also envisaged for Component 2.

### Procurement (based on the Project Procurement Strategy for Development)

**Project Overview**

| | |
|---|---|
| **Country:** | Serbia |
| **Full Project Name:** | State Owned Financial Institutions Reform Project |
| **Total Finance (EUR):** | EUR 40.1 million |
| **Project Number:** | P156837 |

**i. Project Description and Development Objectives:**

**21.** The proposed Serbia results-based State Owned Financial Institutions (SOFI) Reform Project aims to improve the performance of those financial institutions that will remain under state ownership, implement the government`s strategy for state-owned banks, as well as to update the NPL resolution strategy with specific focus on state-owned NPLs and to help in redefining the development finance framework in Serbia.

**22.** The project will have two components:

1) A results-based component that supports the reform of SOFIs based on the achievement of DLIs in line with the government's reform program. DLIs are primarily focused on Banka Poštanska Štedionica (BPS), the development of a new strategy on development finance, resolution of non-performing loans (NPLs) and other SOFI reform (EUR 27,969,750);

2) A technical assistance and investment component that aims at strengthening institutional capacity and finances needed goods and services to support the achievement of DLIs (EUR 12,030,000).

**23.** The TA component will finance activities that aim to:

1) Restructure BPS;
2) Support the MoF in developing and implementing the strategies on NPL resolution and development finance;
3) Support the MoF in meeting its mandate to oversee and implement the reform strategy for SOFIs.

**24.** Items 2 and 3 of the TA component involve only consulting services (both individuals and firms), while item 1 involves BPS goods (IT), consulting services and non-consulting services.

**Strategic Assessment of Country, Borrower and Marketplace**

**a. Operational Context**

**25.** The government is focused on reforming the role of the state in the financial sector with the support of the World Bank and other IFIs. As part of this effort, the Government of the Republic of Serbia has committed to improving the role of the state in the financial sector. There is significant commitment to completing these reforms at the highest levels of the government. We believe that the actions supported by the proposed loan will help improve the efficiency of the financial sector in the country.

**b. Client Capability and PIU (MoFFS) Assessment**

**26.** The project will utilize the services from the Central Fiduciary Unit (CFU) within the MoF for procurement and financial management, and will be complemented by technical staff in the MoF responsible for the financial sector (MoFFS), who will assist in the technical aspects of project implementation. The MoFFS will be in charge of overseeing and executing all other project activities. Project implementation by MoFFS will rely on current resources in the unit (with lack of qualified staff being a serious issue, given that currently there are only two employed civil servants within this MoFFS – Banking unit) as well as additional consultants that will be recruited under the TA component of the project. The implementation arrangements will place an emphasis on strengthening the MoFFS's capacity to oversee SOFIs through monitoring the DLIs and other aspects of the government's SOFI strategy.

**27.** The CFU was established in October 2017 to initially implement fiduciary aspects of the World Bank Early Childhood Education (ECE) Project. It has three qualified staff selected under competitive basis: CFU Director, Procurement Specialist, and Financial Management Specialist.

**28.** However, since additional projects (Swiss TA Grant, Public Sector Accounting Reform TA, etc.) will soon be managed under the CFU, it would be highly important to hire in mid-2018 two additional specialists for both procurement and finance issues to ensure smooth and effective project implementation of SOFI and other projects within the helm of the CFU.

**c. Market analysis**

**29.** It is expected that the majority of the contracts will be consulting services that will involve both individuals and firms. The majority of the individual consultants will be local hires, while the selection of consulting firms will be advertised internationally or locally, depending on the scope of assignment and the prescribed thresholds for high risk projects. There is a significant number of international firms that perform the services related to SOFIs, and thus it is expected that there will be strong interest from the business community for delivering these services.

**30.** For the IT procurement, there is a robust international market for core banking systems, and this contract will be advertised internationally.

**Procurement Risk Analysis**

**31.** The overall coordination, management, implementation and oversight of procurement will be carried out by the CFU which was, as already mentioned, recently established. The initial procurement risk rating is high due to imminent staff capacity and coordination issues.

**32.** Procurement will be conducted in accordance with the World Bank's Procurement Regulations for IPF Borrowers: Procurement in Investment Project Financing – Goods, Works, Non-Consulting and Consulting Services (July 2016). Based on these thresholds, the simplified procurement plan lists the contracts to be financed, the selection/procurement method, estimated cost, review by the Bank, and implementation dates.

**33.** The prior review thresholds for high risk projects as provided in the ECA Regional Procurement Maximum Thresholds, effective January 2, 2014 (revised November 15, 2016) will apply: Goods, IT System and Non-Consulting Services – $1,500,000; Consulting Firms – $500,000; and Individual Consultants – $200,000. Direct Selection will be in accordance with paras. 6.8 to 6.10 for Goods, Works and Non-Consulting Services and paras. 7.13-7.15 for Consulting Services of the Procurement Regulations.

**34.** For the most part, the risks for selection of consulting services are low, since there is a robust market for the services required and they are not high value contracts. However, there is one high value contract related to the selection of a firm (discussed below) for the IT procurement for the core banking system. The firm will be selected using QCBS subject to prior review.

**35.** It was agreed that individual consultants currently employed under the Deposit Insurance Strengthening Project (DISP) will continue their engagement under the SOFI project through Direct Selection (DS) as they have been selected on a competitive basis and their work is relevant to the new project in meeting the DLIs. These individual consultants include the following:

- Head of Legal (Aleksandar Vajagic)
- Senior Legal Consultant (Bojan Resavac)
- Legal Consultant (Ivona Kraktus)
- Junior Legal Consultant (Jelena Malenovic)

**36.** It is important to note that there is no legal department nor even one lawyer in the MoFFS – Banking unit currently. Throughout the DISP duration these four consultants were engaged in this unit, dealing mostly with all legal requirements, different documents (laws, by-laws, regulations, conclusions, etc.) and working on solving legal issues and obstacles. Furthermore, this team had a significant input in creation of important documents including for example the *Decree on the manner and condition regarding sale of shares in state-owned banks*, updated State-owned bank strategy, etc. Coupled with an equally complex legal system in the RoS (courts included in many cases), these consultants have in many ways become vitally important, as they provided, in lots of cases, the only viable access to the legal system and continuous legal support to the MoFFS.

**37.** It is suggested (in the procurement plan table below) that two junior legal consultants should be engaged having in mind serious lack of people with legal knowledge and expertise currently in the MoFFS. By having this so called legal department, the level of quality of the documents that are prepared and issued by this Department should increase significantly. Engagement of additional junior legal consultant could help also in enhancing further the MoFFS capacities and therefore the overall improvement of the documents delivered by the MoFFS,

- Head of CF Analyses (Milos Djordjevic)

**38.** In enabling the MoFFS to continue to smoothly monitor and oversee the performances of the state-owned banks in the future period it is crucial that the high-skilled CF team consisting of several analysts is in place. Since Mr. Djordjevic (coming from the private banking sector) was one of the first to join MoFFS during the DISP it would be beneficial that he continuous to work in the MoFFS during the SOFI Project.

**39.** In the procurement plan table below two CF analyst positions are listed as necessary. The idea is to have a separate CF team (similar to legal department), that should enable monitoring of the activities and performance of the state-owned banks. The CF analysts, shall, among other duties, perform financial statements analysis, a review of the state-owned banks strategy, industry dynamics, and when appropriate use of projections. Since the RoS Government long-term goal is to divest from many state-owned banks it is highly important to have an experienced and well-qualified CF analysts team engaged throughout the SOFI Project.

- Business Analyst (Luka Novakovic)

**40.** Same goes to Mr. Novakovic who spent a lot of time during the DISP working on not just overseeing the performances of the state-owned banks, but also in preparation of different analysis on the performances of Development Fund and AOFI.

**41.** In the procurement plan table below two Senior Business Analysts positions are listed as necessary. These consultants should, when engaged, provide strategic, analytic and project support to the solutions needed for different SOFIs in this Project. We would expect them to play a strong business role by reviewing and analyzing options for improving business solution capabilities to meet the evolving needs of the different state-owned banks and other SOFIs. Of course, it is difficult at this point to be certain whether two consultants would be needed in these positions, but we would suggest to leave these two spots for now, and if necessary changes to the procurement plan can be made at a later stage.

- Senior Insurance Analyst (Srdjan Trajkovic)

**42.** Even though the focus of the SOFI Project is not on Dunav Insurance, given the current capacities in the MoFFS (having only one senior civil servant dealing with the insurance regulation overall), continuation of the engagement of Mr. Trajkovic (at the same time he is an actuary) with his specific in-depth knowledge in the field of insurance seems to be more than needed. This is also important having in mind potential privatization activities of Dunav in the upcoming period.

**43.** In the MoFFs there is currently a lot of activities going on under the capital market unit. It is envisioned that several legislative acts (including Capital Market Law, Investment Fund Law, etc.) shall be subject to changes and amendments in 2018 and the years to come. Given so, the amount of work that needs to be done in the next couple of years in this area requires significant knowledge and expertise that the MoFFS with the current capacities struggles to meet. The purpose of the engagement of two Senior Capital Market Analysts is to ensure that the MoFFS can prepare a sound legal framework with changes that will meet the requirements of the EU *acquis* and the best international practice but also at the same time to pay special attention on the local specifics and improvements that are needed in order to have a stronger, well-trusted capital market that is vital to the functioning of the Serbian economy.

**44.** Most of these consultants (engaged under the DISP) will continue their services with the MoF after the closing of the DISP and before the effectiveness of the SOFI. MoF will pay the consultants based on the MoF salary scale which is much lower than the remuneration in their contracts under DISP. The difference in their salary will be subject to retroactive financing once SOFI becomes effective.

**45.** IT procurement will involve contracts that are of significant value, and thus the corresponding risk will be higher. Preparation of the bidding documents, specifically the technical specifications and setting up the evaluation criteria, might prove to be challenging for the staff. The same could be said for the evaluation of bids. Although continuing reforms in the BPS will be taking place under this project, the Borrower has asked the Bank to include in the project IT and consulting services for the state-owned institution to ensure that procurement is done in a fair and transparent manner. To mitigate the risks, the TA component includes the selection of a consulting firm whose responsibilities will include developing the technical specifications for the RFB and providing advice on the overall process to ensure appropriate oversight from a firm with both technical and procurement experience with core banking systems. The Bank's Standard Procurement Documents (SPDs) will be used. The selection of this firm will be initiated as early as the first quarter of 2018 and to sign the contract on or before project effectiveness. The contract could potentially be under retroactive financing depending on the progress of the selection process which could take between 4-5 months from the time of publication of the Request for Expressions of Interest and depending on the efficiency of the Evaluation Committee in reviewing expressions of interest, shortlisting, and evaluating technical and financial proposals.

**46.** The Ministry of Finance established, in cooperation with the World Bank and IMF, the procurement process of external consultancy services for realization of complex analyses, reports and drafts in accordance with the ToR and with the goal of optimal realization of guidelines set in the BPS Government Conclusion. The main tasks performed by the selected (in May 2017) external Consultant (A.T. Kearney) were included in their report to support the implementation of the new strategy of the BPS. These are related to four major streams:

1. Performance of a detailed analysis of the current conditions and opportunities in the market segments for retail banking, entrepreneurs, micro-enterprises and small enterprises:

2. Performance of a detailed analysis of BPS's current organization, positioning and strategies to promptly achieve the implementation of its new strategy, in accordance with the Government's Conclusion;

3. Performance of a gap analysis with respect to BPS's existing IT platform, inclusive of recommendations with respect to consolidation and optimization of the IT platform to support the bank's new strategy going forward; and

4. Preparation of BPS's business plan for the period 2018-20.

**47.** All of these tasks were completed by the selected consultant in the period May – November 2017. Furthermore, in November 2017, the BPS Board of Directors adopted the final A.T. Kearney report to support the implementation of the new strategy for the Bank. In the upcoming period (starting from 2018) particular focus should be paid on the future implementation of the report's findings and recommendations.

**48.** Within Table 1. Procurement Plan, point 5. Consultant – Advisory Services Business Plan Implementation – the following activities are included: *procurement, work out of NPLs, product development, sales training, risk management training, training for operational departments and staff compensation.*

**Procurement Objectives**

**49.** The procurement objective is to carry out and complete the procedures for all contracts in a timely, efficient, transparent manner with an emphasis on fit-for-purpose, quality and value for money.

**Recommended Procurement Arrangements for the Project**

**50.** The details on each activity, their estimated cost and proposed procurement method are outlined in Table 1.

**Core Banking System for BPS (Development, Installation, and Maintenance)**

- Contract and Estimated Cost: EUR8.02 million
- Procurement Approach: International

| Attribute | Selected Arrangement | Justification Summary/Logic |
|---|---|---|
| Specifications | Performance | This will involve the development of a tailored core banking system. |
| Sustainability Requirements | No | |
| Contract Type | Performance-based or lump-sum | Provision of non-consulting services to be paid on the basis of outputs. |
| Supplier Relationship | Collaborative | In addition to the development of the core banking system, the relationship with the supplier will be long term due to installation and maintenance. |
| Procurement Method | Request for Proposals (RFB) | The Borrower's business needs are better met by allowing bidders to offer customized solutions or proposals. |
| Market Approach | Open<br>International<br>One-Stage<br>BAFO | |
| Pre / Post Qualification | Post Qualification | |
| Evaluation Selection Method | TBD | This will be elaborated in the RFB. |
| Evaluation of Costs | TBD | This will be elaborated in the RFB. |
| Domestic Preference | No | |
| Rated Criteria | Desired | |

**Preferred Arrangement for Low Value, Low Risk Activities**

**Individual Consultants**

**51.** Selection methods are open competition and direct selection. Under open competition, advertisement through REOIs shall include complete TOR. Individual consultants are selected from those that expressed interest in response to a REOI. For direct selection of individual consultants, due justifications under the circumstances specified in para. 7.39 of Section VII of the Regulations apply.

**Consulting Firms**

**52.** The methods to be used for selection of consulting firms are those stated in Section VII. Approved Selection Methods for Consulting Services of the Regulations: QCBS, FBS, LCS, QBS and CQS.

**Table 1. Initial Procurement Plan for SOFI Reform Project**

| # | Activity | Category | Estimated Overall Cost (EUR) | Source of Finance – Loan (EUR) | Prior/ Post | Procurement/ Selection Method |
|---|---|---|---|---|---|---|
| | **TA 1 – Restructuring Banka Postanska Stedionica AD Beograd** | | | | | |
| 1 | Core Banking System for BPS | Non-Consulting Services | 8,020,000 | 4,010,000 | Prior | RFB |
| 2 | IT Procurement and Implementation Support | CS (Firm) | 240,600 | 240,600 | Post | CQS |
| 3 | IT Hardware for Data Center and Branches/Offices | Goods | 1,604,000 | 802,000 | Prior | RFB |
| 4 | IT Procurement Support | CS (IC) | 24,060 | 24,060 | Post | Open Competition |
| 5 | Consultant - Advisory Services Business Plan Implementation | CS (Firm) | 1,523,800 | 1,523,800 | Prior | QCBS |
| 6 | **TA 1 – BPS (points 1–5) – Total Costs** | | **11,412,460** | **6,600,460** | | |
| | **TA 2 – Strengthening Institutional Capacities to Support the Achievements of DLIs** | | | | | |
| 1 | Head of Legal | CS (IC) | 208,520 | 208,520 | Prior | Direct Selection |
| 2 | Senior Legal Consultant | CS (IC) | 176,440 | 176,440 | Prior | Direct Selection |
| 3 | Legal Consultant | CS (IC) | 168,420 | 168,420 | Prior | Direct Selection |
| 4 | Junior Legal Consultant | CS (IC) | 112,280 | 112,280 | Prior | Direct Selection |
| 5 | Junior Legal Consultant | CS (IC) | 112,280 | 112,280 | Post | Open Competition |
| 6 | Head of CF Analyses | CS (IC) | 208,520 | 208,520 | Prior | Direct Selection |
| 7 | Deputy Head of CF Analyses | CS (IC) | 192,480 | 192,480 | Prior | Open Competition |
| 8 | CF Analyst | CS (IC) | 144,360 | 144,360 | Post | Open Competition |
| 9 | CF Analyst | CS (IC) | 144,360 | 144,360 | Post | Open Competition |
| 10 | Junior CF Analyst | CS (IC) | 112,280 | 112,280 | Post | Open Competition |
| 11 | Senior Business Analyst 1 | CS (IC) | 176,440 | 176,440 | Prior | Open Competition |
| 12 | Senior Business Analyst 2 | CS (IC) | 176,440 | 176,440 | Prior | Open Competition |
| 13 | Business Analyst | CS (IC) | 144,360 | 144,360 | Post | Direct Selection |
| 14 | Junior Business Analyst | CS (IC) | 112,280 | 112,280 | Post | Open Competition |
| 15 | Senior Insurance Analyst | CS (IC) | 176,440 | 176,440 | Prior | Direct Selection |
| 16 | Junior Insurance Analyst | CS (IC) | 112,280 | 112,280 | Post | Open Competition |
| 17 | Senior Capital market Analyst | CS (IC) | 176,440 | 176,440 | Prior | Open Competition |
| 18 | Senior Capital market Analyst | CS (IC) | 176,440 | 176,440 | Prior | Open Competition |
| 19 | Strategic Adviser | CS (IC) | 208,520 | 208,520 | Prior | Open Competition |
| 20 | Int'l Adviser for restr. & privat. | CS (IC) | 288,720 | 288,720 | Prior | Open Competition |
| 21 | IT Adviser | CS (IC) | 120,300 | 120,300 | Post | Open Competition |
| 22 | Business Legal Adviser | CS (IC) | 120,300 | 120,300 | Post | Open Competition |
| 23 | Supervision & Control Adviser | CS (IC) | 120,300 | 120,300 | Post | Open Competition |
| 24 | CFU Staff | CS (IC) | 240,600 | 240,600 | Prior | Open Competition |
| 25 | Project Performance & FS audit | CS (Firm) | 56,140 | 56,140 | Post | LCS |

| | | | | | | |
|---|---|---|---|---|---|---|
| 26 | Independent verification of achievement of DLIs/DLRs | CS (IC) | 24,060 | 24,060 | Post | Open Competition |
| 27 | Support in developing strategy for resolving state-owned NPLs, its implementation and sale of state-owned assets | CS (Firm) | 777,940 | 777,940 | Prior | QCBS |
| 28 | Support in creating strategy on development finance | CS (Firm) | 240,600 | 240,600 | Post | QCBS |
| 29 | Support in divesting from SOFIs that will not be retained | CS (Firm) | 376,940 | 376,940 | Prior | QCBS |
| 30 | Operating costs | OC | 24,060 | 24,060 | Post | N/A |
| **31** | **TA 2 - Total Costs (points 1 – 30)** | | **5,429,540** | **5,429,540** | | |
| **TOTAL COSTS (points 6 + 31)** | | | **16,842,000** | **12,030,000** | | |

### Environmental and Social (including safeguards)

53. **The project is rated environmental category C in accordance with the World bank OP/BP 4.01 on Environmental Assessment.** In respect to its activities, the project is environmentally-neutral and has no impacts and risks associated to environmental performance. The project does not trigger any environmental safeguard policies.

54. **The project does not expect to have negative social effects.** The proposed components aim to improve the oversight and performance of SOFIs that the government has chosen to retain, divestment of those that it has chosen not to retain, and the improvement of organizational functioning of BPS. The activities supported by the project will not involve land acquisition or physical relocation. The project does not trigger OP4.12.

55. **The project will have positive impacts on BPS employees by introducing modern human resources and IT systems.** It is expected that BPS will hire new staff with financial risk management expertise. The new human resources system will include a modern approach to career management, training and development, and performance management. However, the restructuring process of BPS associated with Component 2 may potentially identify a need to reduce the number of staff in business functions which will be automatized and rightsized. BPS has 1997 employees (68 percent women) and a large majority (59 percent) have high school level education. The BPS plans to rely on natural attrition and retirement eligibility as methods for staff reduction, since about 15 percent of employees will meet conditions for retirement (old age and early pension) in the period from 2017 through 2020. If there is a need to reduce staffing beyond natural attrition, this risk will be known during project implementation, and downsizing would be carried out during project implementation. In instances where there may be a residual risk of staff rightsizing, this will be managed in accordance with applicable labor law and collective agreements, and all other applicable national legislation as well as good international practice. The applicable labor law and collective agreement includes a requirement for consultations with unions and the national employment service. The labor law provides a definition of staff redundancies in instances of organizational and technological changes. The existing collective agreement provides options for voluntary separation with incentive severance payment, and also includes a procedure, selection criteria and amount of severance payment for involuntary separation (which is above the minimum prescribed by the labor law). The previous experience with staff reductions at BPS indicates that it was carried out on voluntary basis with incentive severance payments. In instances of staff redundancies, the Borrower will inform the Bank and prepare a retrenchment plan acceptable to the Bank and the Borrower will carry out consultation with unions. The proceeds from the World Bank loan will not be used to finance severance payment. If staff

reductions occur during project implementation, the Borrower will submit an implementation report to the Bank after the completion of the process.

**56. Citizen Engagement.** As part of the project preparation, an outreach session was held with businesses and organized by a local business association. During implementation, such outreach sessions will continue to be organized to keep beneficiaries and businesses informed and engaged in the reform process and to close the feedback loop. The project also supported the enactment of government decisions for key elements – the strategy for BPS, privatization of Dunav, and strategy for state-owned banks – that were publicly disclosed in order to ensure transparency about the government's decision related to these institutions.

**57. Gender.** Given the nature of the project, there is no gender specific impact from the project and the project design did not focus on gender disparities in access to finance in Serbia. While gender disparities exist in access to finance in Serbia, they are insignificant. The Constitution of Serbia envisages equal rights of men and women with regard to bank loans and other financial credits. However, in most cases, a condition for obtaining loans is the possession of certain property and since there is a lower proportion of women than men among the owners of collaterals, in practice women are placed in a less favorable position in relation to men. The disparity in owning a collateral is wider in rural areas with women owning only 18 percent of agricultural holdings (OECD, Gender, Institutions and Development Database, 2014). According to the WB's global FINDEX database, in 2014, women slightly lagged behind men with regard to access to savings accounts, with only 8 percent of women compared to 10 percent of men. Similarly, 10 percent of men borrowed from a financial institution in 2014, compared to 8 percent of women. On the other hand, Serbia reached gender parity in accessing bank accounts, as 83 percent of both women and men have an account at a financial institution.

**58. Climate Co-Benefits.** The project has been screened for potential climate co-benefits, but immediate opportunities could not be identified. As part of the work towards a development finance strategy, the working group will deliberate to what extent the promotion of energy efficiency and environmental protection should be part of the development finance framework in Serbia. While it cannot be determined at the current point whether climate aspects will feature in the strategy, awareness can be raised through the project regarding the importance of these topics.

### Monitoring and Evaluation

**59. The MoFFS will be responsible for results monitoring and evaluation.** The MoFFS will be responsible for collecting data required for monitoring and coordination of project activities in accordance with the indicators included in the Results Framework (Annex 1). The CFU will submit semi-annual progress reports prepared by the MoFFs, documenting analysis of implementation progress toward achievement of the PDO, including monitoring of the results framework and DLIs/DLRs, as well an evaluation of FM and procurement.

## ANNEX 3: IMPLEMENTATION SUPPORT PLAN

**COUNTRY: SERBIA**
**State-Owned Financial Institutions Strengthening Project**

### Strategy and Approach for Implementation Support

1. **Implementation Strategy.** The implementation support strategy for this project will include regular dialogue with the MoF, MoE, SOFIs, and technical and fiduciary oversight of the project. Regular dialogue and implementation support will facilitate early identification of problems and obstacles, especially those related to the achievement of DLIs, and enable the Bank to provide timely support to address those problems. Specific skills are required to support the procurement of the core banking system for BPS, and this is reflected in the skills mix. The resource estimate takes the substantial risk of the project into account.

### Implementation Support Plan and Resource Requirements

2. **Table 1 and 2 present the implementation support plan and resource requirements.**

**Table 1: Implementation Support Plan**

| Time | Focus | Skills Needed | Resource Estimate | Partner Role |
|---|---|---|---|---|
| First twelve months | Team Leadership<br>State-owned Banks<br>Development Finance<br>NPL Resolution<br>Financial Management<br>Procurement<br>IT Procurement | Task Team Leader<br>State-owned Banking Expert<br>Development Finance Expert<br>NPL Resolution/ Insolvency Expert<br>Financial Management Specialist<br>Procurement Specialist<br>IT Procurement Specialist<br>Core Banking System Specialist[18] | US$ 180,000 | N/A |
| 12-48 months | Team Leadership<br>State-owned Banks<br>Development Finance<br>NPL Resolution<br>Financial Management<br>Procurement<br>IT Procurement | Task Team Leader<br>State-owned Banking Expert<br>Development Finance Expert<br>NPL Resolution/ Insolvency Expert<br>Financial Management Specialist<br>Procurement Specialist<br>IT Procurement Specialist<br>Core Banking System Specialist | US$ 180,000 | N/A |

[18] Needed until the IT procurement is in the installation phase.

**Table 2: Skills Mix Required**

| Skills Needed | Number of Staff Weeks | Number of Trips | Comments |
|---|---|---|---|
| Team Leader | 8 | 2 | |
| Senior Financial Sector Specialist/ Insolvency expert | 5 | 0 | Based in Belgrade |
| State-owned Banking Expert | 5 | 2 | |
| Development Finance Expert | 4 | 2 | |
| Financial Management Specialist | 3 | 0 | Based in Belgrade |
| Procurement Specialist | 3 | 1 | |
| IT Procurement Specialist | 3 | 1 | |
| Core Banking System Specialist | 3 | 1 | |