



Combined Project Information Documents / Integrated Safeguards Datasheet (PID/ISDS)

Appraisal Stage | Date Prepared/Updated: 16-Jan-2018 | Report No: PIDISDSA21367



BASIC INFORMATION

A. Basic Project Data

Country Serbia	Project ID P156837	Project Name State Owned Financial Institutions Reform Project	Parent Project ID (if any)
Region EUROPE AND CENTRAL ASIA	Estimated Appraisal Date 22-Jan-2018	Estimated Board Date 22-Mar-2018	Practice Area (Lead) Finance, Competitiveness and Innovation
Financing Instrument Investment Project Financing	Borrower(s) Ministry of Finance of Serbia	Implementing Agency Ministry of Finance	

Proposed Development Objective(s)

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

Components

Support the Reform of State Owned Financial Institutions
Strengthen Institutional Capacity

Financing (in USD Million)

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

Environmental Assessment Category

C - Not Required

Decision

The review did authorize the preparation to continue



Other Decision (as needed)

B. Introduction and Context

Country Context

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.

Following lackluster performance since the crisis, Serbia's economic growth is expected to pick up in the context of government 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 the late 2014 the government has put in place an ambitious reform program 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).

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.

Sectoral and Institutional Context

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. 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 and 4 privately-owned domestic banks.

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.

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, resulting in a significantly lower NPL ratio of approximately 15.6 percent as of end Q2 2017, its lowest level since June 2013. Sector profitability steadily improved over the past years with ROE of 10.6 percent as of June 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.

The Republic of Serbia has direct ownership stakes in four banks operating in Serbia: Komercijalna Banka, Banka Postanska Stedionica (BPS), Srpska Banka, and Jubmes Banka. It also has indirect ownership in MTS Banka and Jugobanka-Jugbanka Kosovska Mitrovica and in one savings bank, Tesla Banka, which operates in Croatia. The banks with ownership interest account for approximately 18 percent of assets of the Serbian banking system as of July 2017. Of the banks with state ownership, only Komercijalna Banka and BPS are considered to be of systemic importance.

Role of the State in the Financial Sector

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. 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).

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.

Reform of State Owned Banks



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 130 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.

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 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.

The government has prioritized restructuring BPS to minimize fiscal risk and develop a viable financial institution. In August 2016, the government adopted a conclusion on guidelines for the bank's new business strategy. This requires that the bank exit the medium 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.

Other State Owned Financial Institutions

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.

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.



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.

Given that NPLs have become a potential source of systemic risk, the authorities developed a comprehensive Strategy for NPL Resolution. 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.

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 state owned 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 state owned banks, failed state owned banks as 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. Proposed Development Objective(s)

Development Objective(s) (From PAD)

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

Key Results

The PDO indicators include the following:

- BPS gross amount of performing credit exposures to medium and large private sector enterprises is reduced compared to end-2016
- BPS gross corporate NPLs are reduced compared to end-2016
- State-owned NPLs are reduced compared to end-2016

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.

D. Project Description

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



1. A results-based component of US\$35 million 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 US\$15 million that aims at strengthening institutional capacity and finances needed goods and services to support the achievement of DLIs/DLRs.

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 (US\$35 million)

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. A summary of the DLIs/DLRs is included below.

1. Restructuring BPS. Given the government's decision to retain BPS in the medium term, the bank needs to be restructured in order to reduce fiscal risks and enhance its performance. The results-based component will include DLRs that support the implementation of the governments' conclusion on BPS, which involves reorienting the bank towards retail and micro and small business lending in line with both the Government conclusion and a new business plan, while exiting the corporate lending to large and medium businesses, decreasing its operations with SOEs, and reducing its stock of NPLs.
2. Development Finance and other State-Owned Financial Institutions Reform. The aim of this reform area is to support the other major elements of the government's SOFI reform program. The results-based component will include (i) reforms and development of a strategy in the area of development finance, (ii) implementing the government's strategy for other state-owned banks, and (iii) improving NPL resolution.

Component 2: Strengthen Institutional Capacity (US\$15 million)

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 in the two reform areas is outlined below.

1. Restructuring BPS. This component will primarily co-finance the new core banking system and applications for the bank as well as consulting services needed to support implementation of the bank's new strategy and business plan.



2. Development Finance and other State Owned Financial Institutions Reform. This component will finance consulting services needed to assist the MoF in overseeing SOFIs, implementing the strategy for state-owned banks, and developing the strategies on NPL resolution and development finance.

This component will also finance TA to support the Central Fiduciary Unit (CFU) for performing its functions related to acting as the Project Implementing Unit. Financing will include staffing support for the functions of financial management, procurement and monitoring and evaluation.

E. Implementation

Institutional and Implementation Arrangements

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 project reporting and monitoring responsibilities, including providing consolidated reports on the EEPs. Costs will be shared proportionally among other projects that 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 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.

F. Project location and Salient physical characteristics relevant to the safeguard analysis (if known)

The project will be implemented within existing BPS and MoF offices.

G. Environmental and Social Safeguards Specialists on the Team

Nikola Ille, Environmental Safeguards Specialist

Jelena Lukic, Social Safeguards Specialist



SAFEGUARD POLICIES THAT MIGHT APPLY

Safeguard Policies	Triggered?	Explanation (Optional)
Environmental Assessment OP/BP 4.01	No	OP/BP 4.01 is not triggered. The project is not expected to have any adverse environmental or social impacts. It is estimated that the risk of involuntary redundancy is low. It is planned to manage staff reductions on the basis of retirement. In instances, where there may be a residual risk of staff reductions, this will be managed in accordance with the applicable labor law and existing collective agreement. If during implementation it is confirmed that collective redundancies will occur, the Borrower will prepare a retrenchment plan acceptable to the Bank. The retrenchment plan will be consulted upon with unions.
Natural Habitats OP/BP 4.04	No	
Forests OP/BP 4.36	No	
Pest Management OP 4.09	No	
Physical Cultural Resources OP/BP 4.11	No	
Indigenous Peoples OP/BP 4.10	No	
Involuntary Resettlement OP/BP 4.12	No	
Safety of Dams OP/BP 4.37	No	
Projects on International Waterways OP/BP 7.50	No	
Projects in Disputed Areas OP/BP 7.60	No	

KEY SAFEGUARD POLICY ISSUES AND THEIR MANAGEMENT

A. Summary of Key Safeguard Issues

1. Describe any safeguard issues and impacts associated with the proposed project. Identify and describe any potential large scale, significant and/or irreversible impacts:

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 with environmental performance. The project does not trigger any environmental and social safeguard policies, and it will not require land acquisition or restriction of access to land.

2. Describe any potential indirect and/or long term impacts due to anticipated future activities in the project area:

The project is environmentally-neutral and has no impacts and risks associated to environmental performance. The



restructuring of BPS will include introducing modern human resources and IT systems, as well as hiring of new staff with financial risk management expertise. However, the restructuring of BPS associated with Component 2 may also include a need to reduce the number of staff in business functions which will be automatized and/or rightsized. The likelihood of risk of staff reduction will be known in 2019 - 2020. It was confirmed that staff reduction will prioritize retirement as a method. From 2017 through 2020, about 15 percent of employees will meet conditions for retirement (old age and early pension). In instances, where there may be a residual risk of staff downsizing, this will be managed in accordance with the applicable labor law and collective agreement, and all other applicable national legislation as well as good international practice.

3. Describe any project alternatives (if relevant) considered to help avoid or minimize adverse impacts.

NA

4. Describe measures taken by the borrower to address safeguard policy issues. Provide an assessment of borrower capacity to plan and implement the measures described.

The Project does not trigger any safeguards policies. The existing collective agreement provides options for voluntary separation with incentive severance payment, and procedures, selection criteria and amount of severance payment for involuntary separation. It is expected that the risk associated with staff reduction will be known in 2019 or 2020. The borrower plans to rely on retirement as a method to manage the staff headcount. If during project implementation the risk of staff reduction is confirmed, the Borrower will inform the Bank and will prepare a retrenchment plan acceptable to the Bank. The Borrower will carry out consultation with unions. The applicable labor law and collective agreement provide a requirement for consultations with unions and the national employment service. The current personnel department, which has nine staff members, has experience with handling staff reduction. In the past, BPS carried out downsizing using voluntary leaves with incentive payments as a method. The Project will support the introduction of a modern human resources system, which should improve capacity to manage staff career and training needs, and implement the measures to avoid and minimize downsizing.

5. Identify the key stakeholders and describe the mechanisms for consultation and disclosure on safeguard policies, with an emphasis on potentially affected people.

The need for staff downsizing will be known during project implementation. In instances when such risk occurs, the Borrower will consult with unions and the national employment service. There are two unions at BPS and an applicable collective agreement which provides a requirement for consultations on the proposed retrenchment plan.

B. Disclosure Requirements

C. Compliance Monitoring Indicators at the Corporate Level (to be filled in when the ISDS is finalized by the project decision meeting)

The World Bank Policy on Disclosure of Information

Have relevant safeguard policies documents been sent to the World Bank for disclosure?



NA

Have relevant documents been disclosed in-country in a public place in a form and language that are understandable and accessible to project-affected groups and local NGOs?

NA

All Safeguard Policies

Have satisfactory calendar, budget and clear institutional responsibilities been prepared for the implementation of measures related to safeguard policies?

NA

Have costs related to safeguard policy measures been included in the project cost?

NA

Does the Monitoring and Evaluation system of the project include the monitoring of safeguard impacts and measures related to safeguard policies?

NA

Have satisfactory implementation arrangements been agreed with the borrower and the same been adequately reflected in the project legal documents?

NA

CONTACT POINT

World Bank

Gunhild Berg
Senior Financial Sector Specialist

Borrower/Client/Recipient

Ministry of Finance of Serbia
Dusan Vujovic
Minister
dusan.vujovic@mfin.gov.rs

Implementing Agencies

Ministry of Finance
Dusan Vujovic
Minister
dusan.vujovic@mfin.gov.rs



FOR MORE INFORMATION CONTACT

The World Bank
1818 H Street, NW
Washington, D.C. 20433
Telephone: (202) 473-1000
Web: <http://www.worldbank.org/projects>

APPROVAL

Task Team Leader(s):	Gunhild Berg
----------------------	--------------

Approved By

Safeguards Advisor:		
Practice Manager/Manager:	Mario Guadamillas	16-Jan-2018
Country Director:	Stephen N. Ndegwa	18-Jan-2018