Assesment on Implementation Basel II rules in Serbian Banking Division

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Process of transformation is evident in developed and less developed countries and covers all areas of industry and social life. In accordance with it, the transformation of banking sector is absolute, and it touches our country. The dynamics of transformation depend on the level of country development and happenings in the world economy and politics. The happenings on the world financial market in the last decade, aimed at pure profit increase (without analysis and respecting present risks), resulted from the world economic crisis by the end of 2007. It indirectly makes the process of transformation of the Serbian banking sector more difficult, due to the fact that it depends on creditworthiness and development strength of own customers and socio-political factors in the country. Local banks are organized in a modern way, which is determined by the EU and Basel Committee Rules, and have modern electronic equipment and mainly professional staff. Stronger competition in the local market will make differences between banks more visible (such as high structural imbalance in terms of financial strength and business results, general level of business efficiency is at low level), which makes space for further mergers and acquisitions of the banks, as a way of faster capital strengthening of the banks, and have other advantages connected to the organization and technical support with direct impact on the efficiency and effective use of the funds.

1. Introduction

The last decade of last century and the first year of this century pass in the transformation of non-market economies of the world in terms of market economy. This process affected and is affecting the developed and less developed countries and all areas of economic and social life. Accordingly, the transformation is inevitable in banking. The process of transformation was no exception for our country.The transformation rate depends on the level of development of the country itself and the events in the world economy and politics.

Unreadiness of participants on world financial markets, to have the unexpected losses in the previous century, influenced to a much more systematic and serious approach to managing risk in the financial business. Institutionalized approached to solving the problems was made, and most was done in the development of risk management in banking, where the Basel Committee formulated the general standards and guidance of supervision, and proposes examples of best banking practices in anticipation that the legislative bodies in individual countries will take measures for their implementation so that they match the specific characteristics of domestic systems in the best possible way. In this way, the Committee encourages all member states to respect the general principles and standards of business with no direct attempt to harmonize the techniques used by supervisory authorities. Only after the adoption of national legislation, the Basel Committee recommendations become binding and legal for countries that have decided to implement them.

Decisions made by the Committee represent the commitment of many other countries outside the G-10 countries, given that there are also representatives of other countries. These decisions are related to various financial areas, but they are one of the most important areas related to the harmonization of differences in international supervision in order to make use of two basic principles: that no internationally active bank can not avoid the supervision and that the process of supervision should be adequate.

In 1988, the Committee has decided to introduce a system for measuring capital adequacy, popular as the Basel agreement I. Based on extensive cooperation with banks and other financial institutions, on 26th June 2004 the Committee released a new agreement on the capital, known as Basel II. Revised agreement on the capital, widely accepted and known as Basel II, was officially adopted on 26th June 2004 by the members of the Committee. The aim was to accept the Basel II in the national legislation by the end of 2006, by that time the parallel implementation of existing and new agreements on capital is expected. Also, the plan was to from the end of 2007 to implement the most advanced approaches for measuring the required level of capital.

This paper presents a new set of standards for establishing minimum capital adequacy for banks. Maintaining an adequate level of capital to promotes the general safety in the banking system.

Basel II is an upgrade to the agreement from 1988 in that part that it takes the infrastructure needed to calculate the level of capital, but by increasing the sensitivity to the risks to which the bank is exposed. This is primarily achieved through closer harmonization of capital requirements with risk of losses on the individual placement and through the introduction of a new request for the appropriation of capital for the risk exposure that is caused by deficiencies in the daily operations of the bank (operational risk). In addition, the main innovation of Basel II refers to the introduction of new activities that relate to the requirement for minimum level of capital and these are: the function of monitoring (supervision) and market discipline, which is roused by the risk management improvement .

We can conclude that the main reason for the introduction of a new agreement on capital is the need for greater flexibility and sensitivity to risk. The new Basel Agreement includes three interrelated pillars, which together should contribute to increasing overall stability and security of the financial system. In this, the first pillar has the task to significantly improve the methodology for determining the minimum capital adequacy ratio, while the second and third pillar are the innovation of the supervision process of banks. The first pillar: Request for a minimum amount of capital, which includes credit, market and operational risk. The first pillar of the new Basel agreement defines ways to determine the minimum capital in that way that it gives a possibility to each individual bank to adjust the amount to the actual level of risk from economic losses which the bank is exposed to. The adequacy ratio of the capital can not be less than 8%. The second pillar: The supervision review process, which sets the framework for the supervisory function of the banking system. According to the new Basel agreement the monitoring process or the supervision review, is based on a series of guidelines that indicate the need for banks to assess their capital adequacy in relation to the overall risks they are facing and the need for supervisory authorities to carry out an overview of the process and implement specific measures in response to the adequacy of methods of assessment. This means that the supervisory process is not only focused on the provision of capital adequacy which ensures that risk-taking by a bank, but also to motivate banks to develop and perfect techniques used in the risk management of banks. The third pillar: market discipline, which is a framework for public publishing of the business data of the banks.

In general, the data that the bank will publish should be consistent with the manner in which the bank management evaluates and manages its risk. The publishing of certain sets of business data should provide more effective public information on the types and extent of risks to which the bank is exposed, and provide a consistent and clear basis for comparison, which will result in a more advanced system of risk management and greater security in the financial markets.

Parallel in the EU are the activities in the stronger implementation of Basel II and rounding of the single market of financial services (a key factor in the development and modernization of the entire financial system and economy the EU as a whole) mainly through the unification of legal rules. EU common market seeks the affirmation of the completion of the four great freedoms: freedom of movement of persons, goods, services and capital. The fourth freedom is circled at the least rate and for the last few years has been the focus of the European institutions. Integration of financial markets is a key factor in the development and modernization of the entire financial system and economy as a whole. Validating the fact that the financial services sector deals with the money of its clients, not its own, the first movement was with the regulation of banks, then other financial institutions [1]. It is important to stress that there has not yet been reached a sufficient system of unification and integration of European financial markets. EU member states should by the end of November 2010 create a single payment area (Single Payment Area). EU members are currently working on the harmonization of regulations related to the movement of capital, appropriate financial structures, tax treatment, competition policy, consumer protection policy, and in the field of payment (clearing and settlement). EU countries have passed 42 legislative measures and a variety of different directives. The most significant is the MiFID Directive (Markets in Financial Instrumenst Directive) amending the existing Investment Services Directive and allowing the companies that are registered in one member state to conduct business freely throughout the EU - the so-called single passport. EU establishes a minimum framework around which there is consensus, and the member states are the ones to further regulate a given area with their rerulations.

[1] Directives, as the most important documents in EU, during the harmonization of the legislation, are based on Basel II.

2. The banking market of the rRepublic of Serbia

Benefits of development of the banking market in Serbia in the past, is the dependence and conditionality on socio-political situation and economic changes in the country. Also, a unique feature for the entire period of development of the banking market in the country, is that the banks and credit survive as an indispensable entity of the financial and economic system.

The period of transition in Serbia began in 1992, but the most significant changes take place after the political changes in 2000 when there are conditions for the arrival of foreign investors. A transition period in the development of the country begins, which includes a variety of turbulence. The fastest growth is in the banking sector. Legislation goes towards supporting the development of domestic banking and adaptation to modern trends.

The transformation is a permanent process that aims to convert the economic entities from state-planned system into a system of market regulation or corporate governance and business[2].

In the core of the transformation are the changes in the way of thinking, business behaviour, decision-making and action of all subjects of economic and social life. The transformation of banks, includes changes in property relations, the organization, management, finance, human resources and monitoring of modern technology. All these changes are aimed at more efficient operations, the creation of quality banking products, meeting the needs, demands and desires of contemporary users of bank services, raising the level of services / products, and thus achieving greater profits.

The transformation process is complete and it makes sense if all its parts are implemented, ie. ownership, management, organizational, technological, financial and human resource transformation. Only transformation carried out in all its aspects, will contribute to more rapid development of market economy and increase the level of competition.

When there is talk about transformation of the domestic banking system, it refers to its recovery, the entry of foreign capital and financial market development. This means: the maintaining of restrictive monetary policy by central banks, increasing the degree of independence of central banks, the introduction of hard budget constraints in state spending, recovery of the banking system and privatization of banks, opening for entry of foreign banks and other financial institutions and the introduction of hard budget constraints in companies.

Commitment to a market orientation involves improving management functions at the level of banks, which contributes to adequate credit and risk analysis, the introduction of internal quality control, proper management and monitoring of assets and liabilities of banks. Objective process runs in parallel with the process of financial market development in transition countries.

Currently there are 34 banks operating in Serbia, 20 of which are foreign-owned banks that participate with 76% of the total balance amount i.e. 60% of the total equity of the banking sector[3]. On the domestic banking market there is an extremely high level of competition. The first five banks (in terms of total assets and invested credits) have 46% of the market share (e.g. in Croatia, the first two banks have that percentage of the participation), while the top twelve banks have 69% of the market share. Two banks on the first place have more than 10% market share.

In early 2000 in our country there were 108 operating banks, which indicates that the number of banks decreases, and that same trend will continue in the future. On the one hand, the state does the integration of banks that are state owned (with the aim to create a development bank), while on the other hand there is a takeover of banks in private hands, both at local and regional level. It is important to emphasize that the majority of foreign banks coming to Serbia pointed out that they want to win the minimum 10% of market share, which in the current framework for those who came later can only be achieved by buying other domestic banks, but not organic growth.

Serbian banking sector recorded a positive financial result to the end of 2008 (slow profit growth starts in the last quarter of 2008 because in Serbia in October 2008 there are the effects of the global economic crisis starting to be felt; for the first nine months of 2009

[2] In the light of current world crisis, developed countries, primarily the US and EU, move into the process of nationalization of banks and bank conversions from private property in the state-planned (Marx's position in the "capital" on the road to communism is reviving), to rescue the banks and preserve customer confidence in the banking system primarily because of loss of strict separation of investment and commercial banking (primarily in the business management of high yield without considering the effects of potential risk). On the other hand the problems faced by banks in the state-planned economy are the efficiency of financial resources, problems securing financial resources, and accumulated losses and problems.

[3] Source: web site The Association of the banks of Serbia and the National bank of Serbia.

nine banks reported profit). The profit for the banking sector amounted to 34.9 billions of dinars (8 banks operated with a loss).

Domestic banks are well capitalized, allowing the NBS to have the proactive measures ready for the first and second wave of global economic crisis. Total capital of the banking sector on 31/12/2008 amounted to 4879 million. Capital adequacy is 23% on 31/12/2008. If there should an account be made of the ratio according to Basel II, it would amount to 19% (according to analysis of NBS), which is significantly higher than the EU countries (average of 8% -10%) and environment (15%).

Also, in the previous year there was a high level of collection of loans invested. In 2008 the degree of nonpayment claims in the area of population amounted to 1.5%, while the level of nonpayment claims in the area of the legal entities amounted to 6.3%.

It should be noted that in the previous period, business banks mostly played with the level of reservation in the sense that they released them, to show better business results (since 31/12/2006). Also, the level of reservation indicates that banks have not adequately classified their placement, or did not implement an appropriate percentage of reservation for a specific placement.

Domestic banks earn very high salaries in the repo business (as much as 30% of placements of banks located in these matters), indicating their exclusive orientation toward the profit (given the fact that placements bring to customers less returns and carry greater risks) and selfishness.

At the same time, there is a high level of cross-border credits granted directly to local legal entities through the head offices of domestic banks with foreign capital or specially established investment funds in particular countries with which Serbia has signed an agreement on avoidance of double taxation. As on 31/12/2008 the companies have accumulated amount of foreign debt of about 11.5 billion euros, an increase of 350% for a period of three years (40% placed cross-border loans went through two commercial banks)[4].

It is important to note that the growth rate of the placed housing loans in ratio to the growth of national gross domestic product (2.9%) indicates that Serbia is in the early phase of transition of the financial sector (due to the fact that the indicator in the EU countries is on average 50%)[5].

It is important that local banks are organized in a modern way, arranged by the example of the EU and the rules of the Basel Agreement, and have electronic equipment and generally professional staff.

The problems faced by domestic banks are inefficient management, quality management team and the leadership, knowledge of banking processes and technologies, required additional knowledge in management and the increase the degree of risk.

Key issues for effective management of domestic banks are: the ability to change management, strategic planning and strategic management approach, flexible organizational structure and a strong marketing orientation.

In 2009 level of credits in the use of is slowly growing, both in the segment of the population and economy, thanks to the stimulating and pro-active measures of the NBS to support credit activity of banks and to relax the borrowers who have come to the problem of loan repayment. However, the economy and population are faced with:

1. reduced liquidity as a result of the way of funding in previous years (which will result in difficult servicing obligations to banks and business partners). In terms of reduced liquidity of the real sector (as a result: reduced domestic and foreign demand, problems in the collection of outstanding claims, less availability of new sources of funding, and funding structures not adequate in previous years) servicing liability during 2009 will be subject to potential companies to renew their loans or willingness of foreign lenders to keep their exposure to Serbia, and the effects will depend on financial support to countries and international financial institutions (such as the Vienna initiative, the loan arrangement with the IMF, the support of the Government of Serbia to the economy providing subsidized credit lines to mitigate the effects of the global financial crisis in the amount of 122 billion di-

[4] Source: web site of the National Bank of Serbia and the Banking, special edition No. 3 – The Serbian banking 2008, The association of the banks of Serbia, Belgrade, 2009
[5] Source: Wolf&McGill, Serbia Real Estate Market Projections, Belgrade, March 2008.

nars, etc.). It should be noted that prior to the global economic crisis, banks were stable source of funding for companies[6].

2. increased currency (the basic element of market risk), interest rate and credit risk, which affect the difficulty in payment of obligations and deteriorating the quality of the portfolio[7].

Accordingly, the expected asset quality experiences deterioration (some banks on 30/06/2009 increased the level of reservation four times), and the currency induced credit risk remains the main risk to the stability of the banking and real sectors. Also, there is the increase of importance of the national money market. In the first wave of the crisis, domestic commercial banks to preserve the liquidity advantage of available funds,used the free means placed in the repos in the National Bank of Serbia.

Liquidity ratios indicate that the same one by the largest number of banks is between 1.5 and 2.5 which should confirm a satisfactory level of liquidity.

Active and passive creation of the interest rates from October 2008 was determined by the liquidity of banks. Problems with liquidity increased importance of the domestic money market. Banks' lending interest rates have increased due to increased risk premiums, while passive rates continue to rise.

Taking into account the developments in global and domestic financial market, banks should in future period focus on the collection of its outstanding claims (placed credits) and restructuring of the placement for which there is a problem of charging, as customers' delay at the start of the year increases (in the segment of legal entities is 9.7% and 3.9% in the segment of the population as of 30/11/2009)[8].

It is important to note that the efficiency and effectiveness of the use of total assets are involved at the unsatisfactory level (0.05% and 0.15%), and therefore there are also low rates of profit of own capital and total assets engaged (8.3% and 1,97%). The overall level of the efficient business is at a lower level due to the high structural imbalance between banks in terms of financial strength and results of operations. Strengthening of the competition in the domestic market will make these differences more visible, which expands the space for summing up the domestic banks through the process of mergers, acquisitions and privatization, as ways of strengthening the capital, which carry other advantages of the organizational, technical and technological origin, and ease the way to economical operations and efficient use of resources.

Experience shows that the state is helping the banks, not the economy. Subsidized credit lines banks are taking advantage of refinancing their own loans to legal entities. The banks have: ensured that the classification placement occurs in a lower category (and on that basis increase the reservation level), provided a better line of credit for themselves (part of the risk transferred to the state, lower credit costs - for the reserve and the margin that the state subsidizes) and for the client (a new lower interest rate loans from the previously used), shut down the existing credit obligations on time and the issue of payment of claims prolonged to the next calendar year.

3. Conclusion

National Bank of Serbia at the end of the first quarter of 2008 published the National Strategy in accordance with the Basel II agreement. The main objectives of the introduction of Basel II standards in Serbia are to further strengthen the banking sector and financial system, improve the process of risk management in banks and the process of supervision based on risk, increase transparency and market discipline, align with business conditions in the international market, harmonize with EU regulations - EU Directives 48/2006 and 49/2006, and create stronger links between capital requirements and risks exposure at the level of the bank.

The operating plan for the introduction of international standards in the field of prudential banking supervision, is defined based on the fact that in the previous years actual macroeconomic conditions necessary for the introduction of these standards were made (such as the liberalization of financial markets, stabilization of

[6] Up to 7th April 2009 170 million euros of loan subsidized credits were confirmed. Banca Intesa a.d. Belgrade has been a leader and placed in the first quarter of 2009 112 million euros of the subsidized line (most of it was refinance of its own portfolio). The nex was Commercial Bank a.d. Belgrade. It should be noted that the credit arrangement with the IMF was signed for a period of three years, and its payment is predicted to take place at once at the end of the use period of loans. The question is from which sources will the Republic of Serbia pay this back.

[7] The banking sector in Serbia, closing with 31/12/2008, kept a low indicator of foreign exchange risk of 8% (which is considerably less than 14.7% from 2007).

[8] Source: web site of the association of the banks of Serbia

the financial system, restructuring of the banking industry and its capital, strengthening the supervisory functions of the National Bank of Serbia, the introduction of international accountant standards, etc.). Also, in the last three years, at the request of the National Bank of Serbia, the bank began to meet certain quality standards of qualification, as a first step in preparation for the implementation of the Basel II agreement (eg, improving the internal management structure, clearly defining the strategies and policies for risk management, developing and promoting the culture of risk management including internal revision and complaince, the developing of an effective system of monitoring and internal reporting). The success of the first step allows creating a framework for managing risk in the bank, and the selection and application of models for the calculation of economic capital, as the highest point in the process of risk management.

Operating defines two phases of implementation of Basel II:

1. Complete harmonization of regulatory standards of the Basel II agreement by 2009
2. Application of standards of the Basel II agreement in practice of the domestic banks from 01/01/2011.

Reviewing the results of the questionnaire on the implementation of the Basel II agreement (by the business banks) in Serbia, it can be concluded that the following problems arise in the implementation: the high costs of staff training and building of an information system, improvement of technology, development of models (including the decision on the best approach in accordance with the risk profile of the bank) and databases (the quality of databases, including the time, keeping historical data, understanding data, developing systems for reporting), and a lack of personnel[9].

Also, considering the transparency of the process of introducing the Basel II agreement in Serbia, we can say that there is no official data on the progress of the first phase of the Operational Plan, ie. that deadlines for the adoption and approval of legislation are not met. i.e. there are not any blueprints for the majority of regulations at the site of the National Bank of Serbia. It also does not have the information whether the National Bank succeeded to hire adequate staff on topics relevant to testing of the suitable models for quantify of the risk in accordance with Basel II and the granting the rating to the credit agencies. Therefore, the question is whether we will manage to implement the Basel II agreement in the domestic banking practice starting from 01/01/2011.

In the coming period the steps necessary for Serbia to integrate into a single EU financial services market should be circled. It is very important to be consistent in implementing and applying if we want to be integrated into a single market. It should be noted that the integration of financial markets is a key to the development and modernization of the entire Serbian financial system and economy as a whole. It is realistic to expect that this project will be implemented in determined steps of phases and the dynamics for Serbia's EU accession and EU Directives in the field of finance and banking (primarily the new rules for cross-border payments - revised rules version 256/2001). There is no currently available information about the project on the web site of the National Bank of Serbia.

Finally, it should be noted that the sectors have a high level of structural imbalance between banks in terms of financial strength and operating results, and the overall level of efficiency of business because of that is on the lower level. Strengthening competition in the domestic market will make these differences more visible, which **expands the space for summing up the domestic banks through the process of mergers, acquisitions and privatization**, as well as faster ways of strengthening the capital, carrying other advantages of the organizational, technical and technological, and economical way to facilitate operations and efficient use of resources. Therefore, in Serbia it is necessary to start the process of complete transformation of domestic banks. Also, state should consider that banks will merge into one development bank (three or four banks), which will be sold to other domestic or foreign banks for a period of one year.

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[9] **Source: web site of the National Bank of Serbia**