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Report No. 83536-YF

INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

PROJECT APPRAISAL DOCUMENT

ON A

PROPOSED LOAN

IN THE AMOUNT OF EUR145.3 MILLION (US$200 MILLION EQUIVALENT)

TO THE

REPUBLIC OF SERBIA

FOR A

DEPOSIT INSURANCE STRENGTHENING PROJECT

February 3, 2014

CURRENCY EQUIVALENTS

(Exchange Rate Effective December 31, 2013)

Currency Unit	=	RSD
RSD83.13	=	US$1
US$1	=	EUR0.73

FISCAL YEAR

January 1 – December 31

ABBREVIATIONS AND ACRONYMS

DIA	Deposit Insurance Agency
DIF	Deposit Insurance Fund
DLIs	Disbursement Linked Indicators
EBRD	European Bank for Reconstruction and Development
EC	European Commission
EU	European Union
FSC	Financial Stability Committee
IFRs	Interim un-audited financial reports
IMF	International Monetary Fund
IPF	Investment Project Financing
MoF	Ministry of Finance
MOU	Memorandum of Understanding
NBS	National Bank of Serbia
NPLs	Non-performing loans
P&A	Purchase and assumption
PDO	Project development objective
PIE	Project Implementing Entity
PIT	Project Implementation Team
POM	Project Operations Manual
RoS	Republic of Serbia
TA	Technical Assistance
TOR	Terms of Reference
USAID	United Stated Agency for International Development
WB	World Bank

Regional Vice President:	Laura Tuck
Country Director:	Ellen Goldstein
Sector Director:	Gerardo Corrochano
Sector Manager:	Lalit Raina
Task Team Leader:	Rinku Chandra

REPUBLIC OF SERBIA
Deposit Insurance Strengthening Project

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PAD DATA SHEET

Serbia

Deposit Insurance Strengthening Project (P146248)

PROJECT APPRAISAL DOCUMENT

EUROPE AND CENTRAL ASIA

Report No.: PAD896

Basic Information		
Project ID P146248	EA Category C - Not Required	Team Leader Rinku Chandra
Lending Instrument Investment Project Financing	Fragile and/or Capacity Constraints [ ] Financial Intermediaries [ ] Series of Projects [ ]	
Project Implementation Start Date 28-Feb-2014	Project Implementation End Date 30-Jun-2016	
Expected Effectiveness Date 30-May-2014	Expected Closing Date 30-Jun-2016	
Joint IFC No		

Sector Manager	Sector Director	Country Director	Regional Vice President
Lalit Raina	Gerardo M. Corrochano	Ellen A. Goldstein	Laura Tuck

Borrower: Republic of Serbia			
Responsible Agency: Deposit Insurance Agency (DIA)			
Contact:	Zoran Obradovic	Title:	Director
Telephone No.:	381112075100	Email:	zoran.obradovic@aod.rs

Project Financing Data(in EUR Million)					
[X]	Loan	[ ]	Grant	[ ]	Guarantee
[ ]	Credit	[ ]	IDA Grant	[ ]	Other

Total Project Cost:	145.3	Total Bank Financing:	145.3
Financing Gap:	0.00		

Financing Source	**Amount**
Borrower	0.00
International Bank for Reconstruction and Development	145.3
Total	145.3

Expected Disbursements (in EUR Million)			
Fiscal Year	2014	2015	2016
Annual	0.00	110.00	35.3
Cumulative	0.00	110.00	145.3

Proposed Development Objective(s)

The project development objective is to strengthen the financial and institutional capacity of the Deposit Insurance Agency, so as to enable it to meet its deposit insurance and bank resolution obligations and serve as a core part of financial sector safety net.

Components

Component Name	Cost (EUR Millions) [1]
Strengthen the financial capacity of the DIA	144.23
Strengthen the institutional capacity of the DIA	0.71

Institutional Data

Sector Board

Financial Systems Practice

Sectors / Climate Change

Sector (Maximum 5 and total % must equal 100)

Major Sector	Sector	%
Finance	Banking	50
Public Administration, Law, and Justice	Public administration- Financial Sector	50
Total		100

☑ I certify that there is no Adaptation and Mitigation Climate Change Co-benefits information applicable to this project.

Themes

Theme (Maximum 5 and total % must equal 100)

Major theme	Theme	%
Financial and private sector development	International financial standards and systems	100
Total		100

[1] Total of the two project components is less than the total amount of the loan (EUR 145.3) as the 0.25% front end fee is being paid through the loan proceeds.

Compliance		
Policy		
Does the project depart from the CAS in content or in other significant respects?	Yes [ ]	No [X]
Does the project require any waivers of Bank policies?	Yes [ ]	No [X]
Have these been approved by Bank management?	Yes [ ]	No [X]
Is approval for any policy waiver sought from the Board?	Yes [ ]	No [X]
Does the project meet the Regional criteria for readiness for implementation?	Yes [X]	No [ ]

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

Legal Covenants

Name	**Recurrent**	**Due Date**	**Frequency**
Para. 1, Section IA of Schedule 2	**X**		Continuous

Description of Covenant

The Borrower shall maintain the Project Implementing Entity with the necessary resources to carry out the Project, and with a composition and terms of reference satisfactory to the Bank.

Name	**Recurrent**	**Due Date**	**Frequency**
Para. 2, Section IA of Schedule 2	**X**		Continuous

Description of Covenant

The Borrower shall cause the Project Implementing Entity to maintain the Project Implementing Team at all times during Project implementation with resources and responsibilities satisfactory to the World Bank, including procurement and financial management, and with competent staff in adequate numbers.

Name	Recurrent	Due Date	Frequency
Para. 3, Section IA of Schedule 2	X		Continuous

Description of Covenant

The Borrower shall cause the Project Implementing Entity to carry out the Project in accordance with the Project Operations Manual, and shall not, and shall cause the Project Implementing Entity to not amend or waive any provision thereto without the Bank's prior written approval. In case of any conflict between the terms of the Project Operations Manual and the Agreement, the Agreement shall prevail.

Name	Recurrent	Due Date	Frequency
Para. 4, Section IIB of Schedule 2	X		Continuous

Description of Covenant

In the event that in any given calendar year the DIF Assets become less than the sum of Transfers to the DIF made pursuant to this Agreement, the Borrower shall ensure that each audit report shall confirm that the difference is justified by: payments in an equivalent amount made by the Project Implementing Entity to fulfill its deposit insurance and bank resolution obligations, in accordance with the Borrower's applicable laws and regulations, which payments shall not include repayment of funds borrowed for the above purposes, from entities other than the Borrower; or (ii) an investment loss, when the investment of DIF Assets was made in accordance with the Law on Deposit Insurance.

Conditions

Name	Type
Subsidiary agreement (Article V, para 5.01 (a))	Effectiveness

Description of Condition

The Subsidiary Agreement has been executed on behalf of the Borrower and the Project Implementing Entity.

Name	Type
Project Operations Manual (Article V, para 5.01 (b))	Effectiveness

Description of Condition

The Project Operations Manual, satisfactory to the Bank, has been adopted by the Project Implementing Entity.

Name	Type
Additional Legal Matter	Effectiveness

Description of Condition

Additional Legal Matter consists of the following: namely that the Subsidiary Agreement has been duly authorized or ratified by the Borrower and the Project Implementing Entity and is legally binding upon the Borrower and the Project Implementing Entity in accordance with its terms.

Team Composition		
Bank Staff		
Name	**Title**	**Unit**
Rinku Chandra	Senior Financial Sector Development Specialist	ECSF3
Aleksandar Crnomarkovic	Senior Financial Management Specialist	ECSO3
Kornel Drazilov	Temporary	ECCYU
Jose C. Janeiro	Senior Finance Officer	CTRLA
Aida Japarova	Senior Program Assistant	ECSPF
Ignacio Jauregui	Counsel	LEGLE
Alena Kantarovich	Financial Analyst	ECSF2
Jose M. Martinez	Senior Procurement Specialist	ECSO2
Tatiana Segal	Senior Operations Officer	ECSF1
Rajeev Kumar Swami	Senior Financial Management Specialist	ECSO3
Dusko Vasiljevic	Private Sector Development Specialist	ECSF3
Jasna Vukoje	Program Assistant	ECCYU
Non Bank Staff		
Name	**Title**	
Rasih Engin Akcakoca	Consultant, Bank Resolution	
Gordon Wallace Johnson	Consultant, Bankruptcy and Liquidation	
Andrew Lovegrove	Consultant, Bank Restructuring	
Chris Parel	Consultant, World Bank Operations	
Leslie Kaye Sulenta	Consultant, Deposit Insurance	
David Keith Walker	Consultant, Deposit Insurance	

I. STRATEGIC CONTEXT

A. COUNTRY CONTEXT

1. **Serbia continues to face major economic challenges following the global financial crisis that began in 2008.** The Serbian economy grew rapidly from 2000-2008, with output rising in real terms by nearly 50 percent. With the onset of the global financial crisis, the economy slipped into a recession, which led to a drop of real GDP by 3.5 percent in 2009. The sluggish economic performance in the country since has led to a double-dip recession and GDP growth was once again negative in 2012. GDP growth is estimated to have been 2.4 percent in 2013 and the economic outlook for the immediate future remains cautious at best, with the latest projections for 2014 GDP growth at 1.0 percent.

2. **The government has embarked on an ambitious program of fiscal consolidation and structural reforms, including strengthening the financial sector, since early 2013.** The crisis unearthed key structural weaknesses and obstacles that hamper sustainable economic development and have prompted the need for fiscal consolidation and the acceleration of the unfinished transition to a market economy in Serbia. The government's mid-term reform program aims to tackle many of these challenges and is outlined in the "Fiscal Strategy for 2014 with Projections for 2015 and 2016". It will focus on: (i) ensuring economic and financial stability; (ii) preventing further debt accumulation; and (iii) creating an environment for economic recovery and growth to foster employment and raise living standards.

3. **The government has also demonstrated a strong commitment to the European Union (EU) accession agenda, and as a result EU accession negotiations formally started on January 21, 2014.** EU membership remains a critical driver of policy and the government has made a considerable effort in accelerating the preparation process for EU accession, including engagement on critical issues such as justice sector reforms and rule of law. Popular support for EU membership is also increasing, with a recent poll carried out by the Serbian Integration office indicating that support for membership has increased by 10 percentage points in the past year.

B. SECTORAL AND INSTITUTIONAL CONTEXT

4. **The financial sector in Serbia is dominated by the banking sector, which overall is stable.** The banking sector accounts for 90 percent of financial sector assets and around 80 percent of the country's GDP[2]. Serbian banks, as a whole, are well-capitalized, with capital ratios that continue to exceed 20 percent. The ratio of bank capital to assets, which is a measure of bank solvency and resiliency, shows the extent to which banks can deal with unexpected losses. Serbian banks are also liquid, with core liquid assets/total assets also over 20 percent, and thus well positioned to deal with any shocks.

5. **However, there are some vulnerabilities in the Serbian financial system.** Non-performing loans (NPLs) in Serbia are among the highest in the region at about 20 percent. Although they appear to be well provisioned, a deterioration in economic conditions could lead

[2] All data in paragraphs 4 and 5 are as of the second quarter of 2013.

to a further decrease in asset quality. In addition, three small banks in which the state had an ownership stake (Agrobanka, RBV, and PBB) failed in 2012 and 2013 due primarily to governance weaknesses that led to a significant deterioration in asset quality. These bank failures have raised concerns about the asset quality in some of the remaining state-owned banks. However, the state-owned banking sector is a relatively minor part of the financial system and outside of two banks that have investments from the IFC and EBRD and are in the privatization process, comprises less than 4 percent of total banking sector assets[3]. Finally, the recent bank failures have resulted in the depletion of the Deposit Insurance Fund (DIF), which poses risks to public confidence in the banking system and stability if there is another bank failure in the future.

Box 1: Overview of the Serbian Deposit Insurance Agency and Deposit Insurance Fund

The Deposit Insurance Agency (DIA) in Serbia is a core part of the financial system safety net that deals with problematic banks. The DIA, along with the National Bank of Serbia (NBS) and the Ministry of Finance (MoF), are part of the safety net system that aims to limit the impact of problematic banks on the financial system and the overall economy. The DIA's primary responsibilities include: 1) the resolution of failed banks; 2) the reimbursement of insured depositors through the Deposit Insurance Fund; and 3) the administration of bankruptcies and liquidations of banks in order to recover assets.

The DIF is mainly funded by collecting premiums from banks (currently 0.4 percent of insured deposits on an annual basis). These are then deposited in the DIF account for legally permissible resolution purposes as defined by the Deposit Insurance Law. In order to minimize the possibility of contagion, deposit insurance covers depositors up to a certain insured amount (which in Serbia is EUR50,000) in case of bank failures. The DIA's role in the resolution of failed banks begins when the license has been pulled by the NBS. The DIA has a "loss minimizer" mandate whereby the Agency is responsible for developing a least-cost resolution strategy that aims to protect the funds of the DIF while at the same time ensuring that insured depositors are protected. Under circumstances when DIF resources are insufficient to fully meet resolution costs, budgetary funds are provided to the DIA to backstop any funding shortfalls. In such cases, the "least cost resolution" principles are extended to the use of public funds. Tools available to the DIA include direct payouts to insured deposits, a purchase and assumption transaction with another bank in which the DIF provides financial support, and the establishment of a bridge bank to allow for a more orderly resolution. In addition, the DIA also has responsibility for recovering assets from bankrupt or liquidated banks in order to recover payouts that were provided.

6. **As part of its efforts to minimize the risks that could emerge from these vulnerabilities, the government has started work on preparing a strategy for the State-Owned Banks.** Representing the owner, the Ministry of Finance (MoF) has completed extraordinary audits[4] of all state-owned banks[5] operating in Serbia. Based on the result of these audits, the government has committed to developing a strategy to minimize the risks in the state-owned banking sector and has earmarked funds in the 2014 budget to implement this strategy.

[3] There are seven state-owned banks (with percent of banking assets in parentheses): Komercijalna (11.96%); Postanska (3.03%); Cacanska (1.18%); Srpska (0.76%); Jumbes (0.42%); Jugobanka (0.04%); and Dunav banka (0.25%). Komercijalna and Cacanska both have IFC and EBRD equity investments.

[4] These audits have been conducted to review not only the financials, but also the asset quality and soundness of the bank strategy.

[5] Aside from Cacanska banka which is in the process of privatization.

7. **The government is also preparing a reform program related to the framework for dealing with problematic banks.** While Serbia has an extensive framework for dealing with problematic banks, the failure of several banks in 2012 and 2013 led the government to begin working on a reform program to improve this framework. The framework for dealing with problem banks includes three government entities: i) the NBS; ii) the DIA; and iii) the MoF. The NBS is responsible for bank supervision and all corrective actions prior to revoking the license of a bank. Once the NBS has revoked the license of a bank, the DIA serves as the resolution authority and determines the least-cost methodology for resolving a failed bank and ensures that insured depositors do not suffer any losses. This can be done via a simple payout to the insured depositors up to the coverage limit of EUR50,000, or through other mechanisms that are less costly such as selling the bank through a purchase and assumption transaction. In addition, separate mechanisms exist for dealing with systemically important banks, including the possibility of receivership and the option of setting up a bridge bank. The MoF also plays a role in the process for dealing with problematic banks and primarily protects citizens from the cost of bank failures when the cost exceeds the funds available in the DIF.

8. **The government has put in place a task force to develop specific proposals to improve the framework for dealing with problematic banks.** This includes representatives from the MoF, the NBS, and the DIA, and is being supported by the World Bank, the IMF, USAID, and the EC. Each of the external stakeholders has agreed to a specific technical and financing role, including:

1. *Financing the Deposit Insurance Fund and strengthening the institutional capacity of the Deposit Insurance Agency:* The government has requested a World Bank loan to strengthen the financial and institutional capacity of the Deposit Insurance Agency.
2. *Improving early intervention, particularly for state-owned banks:* The World Bank (through this operation and technical assistance) is supporting the government's efforts to improve its oversight of state-owned banks.
3. *Improving NBS supervision and enforcement:* The IMF conducted a technical assistance mission in early September 2013 to review NBS supervision and enforcement.

In addition, the EC and USAID are providing assistance on drafting any legal changes that are needed to implement the overall reform program.

Role of the World Bank Financed Deposit Insurance Strengthening Project in the Government's Reform Program

9. **The recapitalization of the DIF is necessary as the recent Bank resolutions have depleted the financial resources available in the DIF.** The resolution of Agrobanka, RBV and PBB has resulted in the DIF paying out the full amount of the assets that it had available (EUR211 million in mid-2012)[6]. The depletion of the DIF creates risks to the Serbian financial system. These risks stem from the possibility of not having adequate resources to cover insured depositors at the time of a bank failure. Bank failures, even of a small size bank, have the

[6] The funds available in the Deposit Insurance Fund were depleted by the resolution of Agrobanka, with the government providing the additional financial resources necessary beyond what was available in the DIF. The government provided the financial resources necessary for the resolution of RBV and PBB as the DIF was insolvent at the time.

potential to shake confidence in the entire banking system if depositors lose confidence that their deposits are secure.

10. **The failure of three small state-owned banks since 2012 has not caused depositors to lose confidence in the banking system, in part due to the actions of the Deposit Insurance Agency.** The actions taken by the Deposit Insurance Agency, the NBS, and the MoF ensured that the failures did not result in a larger crisis of confidence in the banking system. As a result, there were no signs of deposit withdrawals or other indicators of deteriorating depositor confidence after the resolution of the three banks.

11. **This document presents a Results Based Investment Project Financing (IPF) to the Republic of Serbia for an amount of EUR145.3 million to support the strengthening of the Deposit Insurance Agency.** Considering the importance of an effective Deposit Insurance Scheme to maintaining confidence in the banking system, this operation aims to strengthen the financial and institutional capacity of the Deposit Insurance Agency, so as to enable it to meet its deposit insurance and bank resolution obligations and serve as a core part of the financial safety net.

II. PROJECT DEVELOPMENT OBJECTIVE

A. PDO

12. **The Project Development Objective is to strengthen the financial and institutional capacity of the Deposit Insurance Agency, so as to enable it to meet its deposit insurance and bank resolution obligations and serve as a core part of financial sector safety net.**

B. PROJECT BENEFICIARIES

13. **The project will strengthen confidence in the financial system.** Deposit Insurance Schemes are a core part of the financial safety net that aims to improve confidence in the financial system. This can lead to an increase in the amount of domestic savings that can be mobilized for more productive uses, which, in turn, can lead to increased growth and job creation. Banks that operate in Serbia will also benefit from the ability of the Deposit Insurance Agency to meet its deposit insurance and resolution obligations, as it minimizes the chances of a small banking failure from becoming a system-wide issue that would negatively impact the operations of all banks.

14. **Households and small and medium enterprises that have deposits in the banking system will benefit from the project.** The Deposit Insurance Fund protects depositors up to an insured limit of EUR50,000. Strengthening the Deposit Insurance Agency and financing the DIF will ensure that these banking customers are protected in the case of a bank failure.

C. PDO LEVEL RESULTS INDICATORS

15. **The PDO will be assessed based on:**

(i) cumulative inflows into the Deposit Insurance Fund equivalent to 2.5 percent insured deposits;

(ii) the DIA performing its legally-mandated technical functions in any future bank failures in which DIF resources are utilized.

16. **These PDO level results indicators correspond to a series of disbursement linked indicators (DLIs) that will be utilized to achieve these results.** Annex 2 (Table 9) presents the DLIs and the targets for disbursement.

III. PROJECT DESCRIPTION

A. PROJECT COMPONENTS

17. **The Project Development Objective will be accomplished through:**

a. financing the DIF with sufficient resources (from external creditors, government budget, bank premiums, recoveries, and investments[7]) to allow the Deposit Insurance Agency to meet its deposit insurance and bank resolution obligations and serve as a core part of financial sector safety net.

b. ensuring that the Deposit Insurance Agency has the institutional capacity to manage the financial resources it has available.

18. **Considering the importance of not only financing the DIF, but also strengthening the Deposit Insurance Agency, the majority of the project consists of a results-based component that finances the DIF based on the achievement of Disbursement Linked Indicators (DLIs).** This is complemented by a technical assistance component that provides assistance in achieving the DLIs and strengthens the institutional capacity of the DIA. Thus the project has two Components that aim to accomplish the Project Development Objective:

1) A results based component of EUR144.23 million that strengthens the financial capacity of the DIA based on satisfactorily achieving DLIs that improve the ability of the DIA to meet its deposit insurance and bank resolution obligations.

2) A technical assistance component of EUR0.71 million that aims to strengthen the institutional capacity of the DIA to meet its deposit insurance and bank resolution obligations and achieve the DLIs.

Component 1: Strengthen the financial capacity of the DIA (EUR144.23 million)

19. **This Component aims to finance the DIF with EUR144.23 million in 2014 and 2015.** The eligible expenditure in this component is the financing of the DIF. Pursuant to OP/BP 10.00, such expenditure meets the productive use requirements as financing for a Deposit Insurance Scheme helps increase confidence in the financial system. This, in turn, is likely to lead to increased deposits in the banking sector, which can be utilized for more productive uses. The Bank has financed Deposit Insurance Schemes through IPF instruments in the past and the eligibility under OP/BP 10.00 has already been established.

[7] The sources of funding are defined in the Deposit Insurance Law

20. **The World Bank financing will be disbursed based on evidence of the financing of the DIF and achievement of six Disbursement Linked Indicators that aim to achieve the PDO by:**

a. *financing the DIF with sufficient resources (from external creditors, government budget, bank premiums, recoveries, and investments) to allow the Deposit Insurance Agency to meet its deposit insurance and bank resolution obligations and serve as a core part of financial sector safety net..*

- DLI #1 - Premiums: Increase premiums charged to banks to increase the flow of funds to the DIF.
- DLI #2 – Back-up funding: Ensure that the government puts in place a stand-by facility that the DIF can access.

b. *ensuring that the Deposit Insurance Agency has the institutional capacity to manage the financial resources it has available.*

- DLI #3 – Governance: Improve the independence of the governance bodies of the DIA.
- DLI #4 – Information sharing between financial safety net providers: Ensure that the DIA has the appropriate information to fulfill its mandate.
- DLI #5 – Recoveries: Improve the performance of the DIA's mandate to recover assets from bankrupt and liquidated banks.
- DLI#6 – Early detection and timely intervention: Improve the information base on state-owned banks to ensure early detection and timely intervention.

21. **As outlined above in paragraph 20, two DLIs will be utilized to accomplish the objective of sufficiently financing the DIF.** The DIF must be restored to a level that provides credible protection against future bank failures in the near term utilizing the sources of funds outlined in the law. Based on analysis conducted (see annex 2 for more details), a target level of DIF funding of 2.5 percent of insured deposits is needed in the short-term. For example, at 2.5 percent of insured deposits, the target fund would be approximately sufficient to cover the cumulative insured deposit amount of the 10 smallest (out of a total of 30) banks in Serbia or the total insured deposits of the 11th largest bank.

22. **The first DLI will put in place an extraordinary premium of 0.2 percent of insured deposits per annum in 2014 and 2015.** This combined with the financing for the DIF provided as part of Component 1 in the amount of EUR144.23 million will achieve the target level of 2.5 percent of total insured deposits by early 2016[8]. The premium increase will result in a 50 percent increase in the fee income from the EUR46 million collected in 2013 and result in approximately EUR69 million in fee income in 2014. Based on an expected growth of insured deposits in 2015, fee income is likely to be slightly above EUR72 million in 2015.

[8] Assuming that there are no additional outflows from the DIF or significant increases in the amount of insured deposits in the banking system.

23. **The second DLI will ensure that the DIA has access to a guarantee or stand-by facility that it can readily access in case it runs out of funds.** Best practice for Deposit Insurance Schemes includes having a back-up facility that ensures that funds can be accessed without parliamentary approval during a time of banking instability. Thus the second DLI ensures that the government puts in place a guarantee or stand-by facility of at least EUR200 million in 2014 and EUR50 million in 2015 (the decrease is due to the increase in financial inflows into the DIF during 2014).

24. **As outlined in paragraph 20, four DLIs will be utilized to accomplish the objective of ensuring that the DIA is able to manage the financial resources in the DIF.** The DLIs aim to: 1) improve the governance of the DIA; 2) improve the information sharing between the NBS and the DIA; 3) strengthen the results from the recovery process; and 4) improve early detection and timely intervention (particularly for the state-owned banking sector).

25. **In order to increase the independence of Managing Board of the DIA, the third DLI will aim to introduce a majority of independent board members.** This will be accomplished by changing the composition of the Managing Board and introducing at least one independent Board member in 2014 and a total of three independent Board members in 2015 (while at the same time reducing the number of Board members representing the authorities to two, one appointed by the MoF and one by the NBS).

26. **In order to strengthen the coordination between the financial safety net providers, the fourth DLI will target the sharing of key data between the NBS and the DIA that are necessary for the DIA to meet its mandate.** Specifically, the DLI will ensure that the following information is shared between the NBS and the DIA: i) the risk profile of all problematic banks in Serbia as computed by the NBS; (ii) conclusions of supervision reports for banks which are considered problematic; and (iii) details on all enforcement actions and compliance related to problematic banks. In addition, the DLI will put in place a regular Financial Stability Committee that will involve quarterly meetings that include the Minister of Finance, the Governor of the NBS and the Director of the Deposit Insurance Agency[9] to discuss problematic banks in detail.

27. **The Deposit Insurance Agency's mandate also includes collecting receivables from bank bankruptcies and liquidations.** There are currently 18 banks in bankruptcy (most from the early 2000's) that are being managed by the DIA. The fifth DLI will support the improvement in the rate of recovery during the next two years.

28. **The three recent bank failures demonstrated the need to ensure the appropriate level of early detection and timely intervention to minimize the potential cost of any bank failures.** Although this applies to all banks that operate in Serbia, considering that the three recent failures were banks in which the state had an ownership stake, the sixth DLI will target improving the quality of information that the DIA and the government, as the owner, receives on the remaining banks in which the state has an ownership stake. This will ensure early detection and timely intervention if any problems do exist.

[9] There are other members of the Committee including additional members from the NBS, MoF and Securities Exchange.

Component 2: Strengthen the institutional capacity of the DIA (EUR0.71 million)

29. **This Component will finance technical assistance (TA) in critical areas that are needed to achieve the DLIs (Component 2a).** Technical assistance will include:

- *Governance*: A senior international expert will be hired to advise the Managing Board and management of the DIA.
- *Information sharing between safety net providers*: Consulting services will be provided to ensure that the DIA has the adequate technical capacity and staffing to utilize the information that it is provided by the NBS.
- *Recoveries*: Consulting services will be provided to improve the recoveries process.
- *Oversight of state-owned banks*: Consulting services will be provided to increase the capacity of the MoF to oversee the state-owned banks.

30. **This Component will also finance TA to support the DIA in performing its functions related to acting as the Project Implementing Entity (Component 2b)**. This will finance the monitoring and evaluation functions related to the DLIs, as well as other critical functions to strengthen the project implementing entity related to financial management and procurement.

Project Financing

31. **As mentioned earlier, the project has two Components of EUR144.23 million and EUR0.71 million.** Details of the project cost and financing are provided in the table below. IBRD financing is not subject to government tax.

Project Cost and Financing

Project Components	Project cost (EUR)	IBRD or IDA Financing (EUR)	% Financing
1. Strengthen the financial capacity of the DIA	144.23 million	144.23 million	100%
2. Strengthen the institutional capacity of the DIA	0.71 million	0.71 million	100%
Total Project Costs	144.94 million	144.94 million	100%
Front-End Fees[10]	0.36 million	0.36 million	
Total Financing Required	145.30 million	145.30 million	100%

B. Lessons Learned and Reflected in the Project Design

32. **Past financial sector operations in Serbia have helped put in place a strong legal framework, but at this stage in the development of the financial sector, sustained implementation is crucial.** Previous financial sector lending operations in Serbia have primarily been DPLs, which have focused on developing a robust legal and institutional framework. This included the 2011 Serbia Policy Based Guarantee that supported several reforms related to the

[10] The exact amount is 0.25% of 145.3 million, which to the nearest Euro is 363,250. The exact amount of component 1 is EUR 144,230,000 and component 2 is EUR 706,750.

DIA. In addition, the World Bank has supported a number of technical assistance projects related to the Deposit Insurance Agency, including a note prepared as part of the 2009 FSAP. One of the important lessons from previous engagements is that a good legal framework is a prerequisite for a stable and functional financial system, but that appropriate implementation is equally important. With this in mind, and considering that a solid legal and policy framework is already in place, the focus of this operation is on sustained implementation and institutional performance. A Results-Based IPF is considered to be the optimal instrument to achieve this goal, as by design it focuses more on achieving and sustaining actual results rather than policy changes.

33. **The World Bank has had success in financing Deposit Insurance Schemes[11].** These have shown that strengthening the financial and technical capacity of Deposit Insurance Schemes can successfully help increase depositor confidence and assist in institution building of a critical part of the financial safety net. Past projects have also shown that it is critical to include technical assistance as part of the overall design of the project. Based on this experience, a technical assistance component has been included in this project.

IV. IMPLEMENTATION

A. INSTITUTIONAL AND IMPLEMENTATION ARRANGEMENTS

34. **The DIA will serve as the Project Implementing Entity (PIE) for both Components 1 and 2.** The institutional and implementation arrangements are relatively straight forward, as Component 1 has relatively few disbursements against a relatively small number of DLIs, and Component 2 involves a small number of consulting contracts. In order to facilitate the project, a Project Implementation Team (PIT) has been established in the DIA. The principal PIT activities will comprise: (i) verifying DLIs achievement for purposes of disbursement; (ii) reporting on the Bank advances that result in the financing of the DIF; (iii) managing TA procurement; and (iv) liaising with and reporting to the government and with the World Bank on project progress. The PIT that has been established includes the same staff that implemented the World Bank's Pensions Administration project that closed in 2012.

35. **The Borrower shall, at all times, ensure that, the Project Implementing Entity maintains** governance arrangements and a financial management system adequate to reflect the operations, resources and expenditures of the PIT, acceptable to the Bank.

B. RESULTS MONITORING AND EVALUATION

36. **Annex 1 lists the main outcome indicators for the project and the principal results, and Annex 2 (Table 9) lists the DLIs.** These will serve as the basis for results monitoring and evaluation. The DIA will be responsible for collecting the data required for monitoring and evaluation and for verification of the DLIs based on protocols outlined in Annex 3 (Table 10).

[11] Asli Demirgüç-Kunt, Edward J. Kane and Luc Laeven: "Deposit Insurance around the World: Issues of Design and Implementation", The MIT Press, 2008

Indicators will be measured against agreed targets and compared to defined baselines. Project progress reports will be prepared by the DIA on a semi-annual basis.

C. SUSTAINABILITY

37. **The sustainability of the DIA will be strengthened through the design of the project.** The project was designed as a Results-Based IPF in order to improve the sustainability of the DIA. The project not only finances the DIF, but also strengthens the institutional capacity of the DIA through the achievement of the DLIs and the technical assistance component.

V. KEY RISKS AND MITIGATION MEASURES

A. RISK RATINGS SUMMARY TABLE

Risk Category	Rating
Stakeholder Risk	Moderate
Implementing Agency Risk	
- Capacity	Low
- Governance	Moderate
Project Risk	
- Design	Low
- Social and Environmental	Low
- Program and Donor	Substantial
- Delivery Monitoring and Sustainability	Low
- Sector Risk	Substantial
Overall Implementation Risk	Substantial

B. OVERALL RISK RATING EXPLANATION

38. **The overall implementation risk is considered substantial.** The major risks relate to the current fiscal situation in Serbia and potential vulnerabilities in small pockets of the financial sector. In addition, although there is a comprehensive fiscal reform program that is being planned, there are risks related to this reform program losing momentum due primarily to possible political uncertainty. The World Bank lending operation is also part of an overall government financial sector reform program and the sustainability of the project partially depends on the successful implementation of the overall reform program.

39. **However, the risks related to the design of the project, the delivery monitoring and risks related to the implementing agency are low.** The achievement of the PDO is dependent on DLIs being met. Considering that disbursements are contingent on achieving the DLIs (and thus the PDO), the design of the project is considered to be low risk. In addition, the technical assistance being provided in Component 2 further decreases the risk that the DLIs (and thus the

PDO) are not met. The delivery monitoring risk is also low as there are a small number of DLIs that will need to be monitored and the monitoring is being done by the same agency that is responsible for achievement of the majority of the DLIs. The DIA, as the project implementing entity, also has experience with World Bank lending operations that span almost a decade and has the capacity and the experience to implement the project.

40. **As an additional safeguard to mitigate project risks**, the loan agreement allows for the project to be suspended if the legislation related to the DIA and DIF has been amended, suspended, abrogated, repealed or waived so as to affect materially and adversely the DIA's ability to perform any of its obligations under the project agreement and carry out its deposit insurance and bank resolution obligations. In addition, the required project audits will be extended to include verification of the DLIs and also verify that any of the World Bank financing of the DIF that is utilized only for deposit insurance and bank resolution functions.

VI. APPRAISAL SUMMARY

A. ECONOMIC AND FINANCIAL ANALYSIS

41. **The nature of the proposed investment that is being financed in this project does not lend itself to traditional economic and financial analysis approaches.** However, there is a significant amount of evidence that supports the development impact and public sector provisioning in developing the financial and technical capacity of a deposit insurance scheme.

42. **Effective deposit insurance can help prevent bank failures from turning into a full blown banking crisis, which can be extremely costly**. According to Laeven and Valencia (2012)[12], the median impact of a banking crisis in emerging economies has been an output loss of 26 percent of GDP and an increase in public debt of 9 percent of GDP.

43. **By reducing the fears about the safety of banks that can cause bank runs, deposit insurance makes the banking system more stable so that banks can safely lend more of their deposits.** According to Demirgüç-Kunt, Kane and Laeven (2008)[13] properly designed and credible deposit insurance systems can enhance financial stability by making depositor runs less likely. It can also lower the risk premiums that consumers pay for bank loans and lead to lower interest rates for household financing.

B. TECHNICAL

44. **The design of the project utilized an evaluation of the Serbian Deposit Insurance System based on the Core Principles of Effective Deposit Insurance.** The Core Principles of Deposit Insurance were adopted by the International Association of Deposit Insurers (IADI) and Basel Committee on Banking Supervision in 2010 and encompass 18 principles that are critical for an effective Deposit Insurance Scheme. The evaluation during the preparation of the project revealed that the Serbian Deposit Insurance System was compliant with most of the principles,

[12] Luc Laeven, Fabián Valencia: "Systemic Banking Crises Database: An Update", IMF Working Paper 12/163
[13] Asli Demirgüç-Kunt, Edward J. Kane and Luc Laeven: "Deposit Insurance around the World: Issues of Design and Implementation", The MIT Press, 2008

but that there were five areas in which the Deposit Insurance System is not compliant. These five areas could be strengthened as outlined below, along with how the evaluation influenced the design of the project:

1. Funding principle: "A deposit insurance system should have available all funding mechanisms necessary to ensure the prompt reimbursement of depositors' claims including a means of obtaining supplementary back-up funding for liquidity purposes when required. Primary responsibility for paying the cost of deposit insurance should be borne by banks since they and their clients directly benefit from having an effective deposit insurance system."
   - *Evaluation of the Serbian Deposit Insurance System:* The Serbian DIF is currently insolvent and thus is not compliant with this principle. In addition, supplementary back-up funding is not available.
   - *Impact on the Design of the Project:* In addition to the financing being provided by Component 1, one of the DLIs focuses on ensuring that the banks themselves bear primary responsibility for recapitalizing the DIF (by increasing premiums temporarily). A second DLI puts in place a back-up funding for the DIF.

2. Governance principle: "The deposit insurer should be operationally independent, transparent, accountable, and insulated from undue political and industry influence."
   - *Evaluation of the Serbian Deposit Insurance System:* The Serbian DIA's Managing Board primarily consists of representatives of the government (the Minister of Finance, the Minister of Economy, and representatives of the NBS). This potentially limits the independence of the DIA.
   - *Impact on the Design of the Project:* One of the DLIs in Component 1 changes the composition of the Managing Board of the DIA to improve its independence. In addition, technical assistance is provided in Component 2 for an advisor to the Managing Board to ensure that the new Board has the capacity to fulfill its mandate.

3. Relationships with other safety-net participant's principle: "A framework should be in place for the close coordination and information sharing, on a routine basis as well as in relation to particular banks, among the deposit insurer and other financial system safety-net participants. Such information should be accurate and timely (subject to confidentiality when required). Information-sharing and coordination arrangements should be formalized."
   - *Evaluation of the Serbian Deposit Insurance System:* A Memorandum of Understanding (MOU) is currently in place that outlines the information that is shared between the NBS and the DIA. However, the MOU is not fully sufficient and does not ensure that the proper information is shared with the DIA on a timely basis.
   - *Impact on the Design of the Project:* One of the DLIs in Component 1 improves the information that is shared with the DIA by the NBS to ensure that it has sufficient information on problematic banks to meet its mandate. In addition, technical assistance as part of Component 2 ensures that the DIA has the capacity to utilize the information properly.

4. Recoveries principle: "The deposit insurer should share in the proceeds of recoveries from the estate of the failed bank. The management of the assets of the failed bank and the recovery process (by the deposit insurer or other party carrying out this role) should be guided by commercial considerations and their economic merits."

- *Evaluation of the Serbian Deposit Insurance System:* The Serbian DIA does currently share in the proceeds of the recoveries from failed banks in which it provides funding. However, the current framework does not produce results that are speedy enough to be compliant with this principle.
- *Impact on the Design of the Project:* One of the DLIs in Component 1 improves the performance of the recoveries process that is managed by the DIA. In addition, technical assistance is provided as part of Component 2 to support the necessary changes to the recoveries process that need to be made to improve the results.

5. Early detection and timely intervention and resolution principle: "The deposit insurer should be part of a framework within the financial system safety net that provides for the early detection and timely intervention and resolution of troubled banks. The determination and recognition of when a bank is or is expected to be in serious financial difficulty should be made early and on the basis of well-defined criteria by safety-net participants with the operational independence and power to act."
   - *Evaluation of the Serbian Deposit Insurance System:* Although there is a need to ensure the early detection and timely intervention for all banks, considering that the recent failures involved banks in which the state had the largest ownership stake, there are concerns about the accuracy of the information on some (particularly the smaller ones) of the state-owned banks. Without accurate information on these banks, there is a gap in the ability to intervene appropriately if problems do arise.
   - *Impact on the Design of the Project*: One of the DLIs in Component 1 requires an audit of the asset quality and financial health for the remaining state-owned banks to ensure the accuracy of the information available. In addition, the same DLI ensures that the MoF, as the owner, collects accurate information on the state-owned banks on a timely basis. Component 2 also includes technical assistance for the MoF to develop the capacity to monitor the state-owned banks.

C. Financial Management

45. **Two separate Designated Accounts for the project (separate for Components 1 and 2) will be held in the NBS.** The control environment within the NBS is considered acceptable.

46. **Interim un-audited financial reports (IFRs) consolidated for the whole project (covering both Components 1 and 2) will be prepared for each calendar semester and will be due 45 days after the end of each semester.** An Annual audit of the project financial will be conducted by a private audit firm acceptable to the Bank. Since the PDO is to strengthen financial and institutional capacity of DIA, an entity audit of the DIA will also be required for all calendar years from effectiveness to the project closing.

Component 1: Strengthen the financial capacity of the DIA (EUR144.23 million)

47. **This Component aims to finance the DIF.** With respect to withdrawals under this Component, withdrawals from the Designated Account for this Component shall be made for a respective DLI upon submission by the Borrower, through the Project Implementing Entity, of: (i) evidence satisfactory to the Bank that transfers to DIF have been made; and (ii) supporting documentation confirming the achievement of the respective DLI or DLIs.

48. **The Borrower may withdraw an amount not to exceed the equivalent of EUR54,490,000 as an advance under Component 1.** However, if the DLIs are not achieved (or only partially achieved), the Borrower will be required to refund the advance.

49. **For the purposes of withdrawals under this component**, the deposits (that are not to exceed the amount outlined above) will be transferred to the foreign currency account (EUR) administered by the DIA (the Designated Account for component 1) within the NBS that is opened and used solely for proceeds from the loan account. The deposits will then be transferred to DIF's foreign currency account, exclusively for the purposes of financing the DIF, within seven days after the advance from the Bank to the Designated Account. Each financing of the DIF will be confirmed to the Bank within 30 days of it occurring, through delivering appropriate documentation evidencing the financing of the DIF. Such documentation will include: bank account statement for the Designated Account showing the transfer to the NBS for deposit in the DIF account; bank account statement from the NBS showing the transfer, and corresponding credit, to the DIF account; letter from the NBS confirming the receipt of funds from the Designated Account, and the deposit of the equivalent amount into the DIF account.

50. **Appropriate documentation evidencing the financing of the DIF and evidence of the achievement of DLIs will constitute the eligible expenditure.** Statements of Expenditures will be utilized to document eligible expenditures under this Component of the Project and the disbursement method will be advances. Each DLI is given a Euro value (see Table 9), and subsequent withdrawals up to the same amount as the value of the DLI met to the Designated Account will be made based on evidence of the financing of the DIF and verification of achievement of individual DLIs being met. The achievement of DLI 1 and DLI 2 is time-bound and may be reduced proportionately on a percentage basis corresponding to the respective degree of DLI achievement. The achievement of DLI 3, 4, 5, and 6 is not time bound (although Table 9 provides indicative time frames for their achievement) and thus a future withdrawal can only be given if the DLI is achieved fully along with a Statement of Expenditures confirming eligible expenditure for that amount.

51. **The Bank shall not be required to make further deposits into the Designated Account, for the Component 1 if:** (i) the Bank, at any time, is not satisfied that evidence and supporting documentation required as specified above and in the Project Operating Manual (POM); or (ii) the Borrower shall have failed to furnish to the Bank, within the period of time specified, any of the audit reports required to be furnished to the Bank.

52. **If the Bank determines at any time that any payment out of the Designated Account was made for an expenditure, which is not an Eligible Expenditure, or was not justified by the evidence furnished to the Bank**, the Borrower shall, promptly upon notice from the Bank, provide such additional evidence as the Bank may request, or deposit into the Designated Account (or, if the Bank shall so request, refund to the Bank) an amount equal to the amount of such payment. Unless the Bank shall otherwise agree, no further deposit by the Bank into the Designated Account shall be made until the Borrower has provided such evidence or made such deposit or refund, as the case may be. Refunds to the Bank made shall be credited to the Loan Account for subsequent withdrawal or for cancellation in accordance with the provisions of the Loan Agreement.

53. **Considering the importance of the DLIs to achieving the PDO, the scope of the annual audit will be extended to provide independent verification of the achievement of DLIs.** The annual audit will also ensure independent verification that any of the World Bank financing for the DIF that has been utilized was used solely for deposit insurance and bank resolution functions in accordance with the applicable laws and regulations.

Component 2: Strengthen the institutional capacity of the DIA (EUR 0.71 m)

54. **Due to the small number of contracts and transactions under the component,** excel files are deemed to be sufficient for maintaining accounting records and preparing Interim un-audited financial reports (IFRs) for the component. Statements of Expenditures will be utilized to document eligible expenditures under this component of the project and the disbursement method will be advances.

55. **Due to the straightforward design and small size of this Component, the existing system of internal controls within the project implementing entity will be used as the basis for internal controls and procedures.** Those procedures and controls to be applied in this Component will be described in the POM that will be prepared by project effectiveness. The foreign currency Designated Account for Component 2, to which the funds will be withdrawn to/paid from, will be opened in the NBS and will be administered by the PIE.

D. PROCUREMENT

56. **The PIT will carry out all procurement activities financed under the project and will include staff with the needed experience in World Bank-financed procurement.** All contracts (including those that benefit the MoF) will be signed by the project implementing entity. The different procurement methods or consultant selection methods, estimated costs, prior review requirements, and time frame will be agreed between the Borrower and the Bank and reflected in the Procurement Plan.

57. **A draft 18-month Procurement Plan has been developed during appraisal.** The plan was agreed upon between the government and the Bank during negotiations and will be available in the project's database posted on the Bank's external website and official public procurement website. The Procurement Plan shall be updated at a minimum annually or as required, to reflect the actual project implementation needs and improvements in institutional capacity. The updated plan will be subject to Bank's approval.

E. SOCIAL AND ENVIRONMENT (INCLUDING SAFEGUARDS)

58. Project Components 1 and 2 do not trigger any World Bank environment or social safeguards policies. Therefore, the project has been assigned a Category 'C' in accordance with the World Bank safeguard policy OP/BP/GP 4.01.

ANNEX 1: RESULTS FRAMEWORK AND MONITORING

REPUBLIC OF SERBIA: Deposit Insurance Strengthening Project

Project Development Objectives

PDO Statement

The project development objective is to strengthen the financial and institutional capacity of the Deposit Insurance Agency, so as to enable it to meet its deposit insurance and bank resolution obligations and serve as a core part of financial sector safety net.

These results are at	Project Level

Project Development Objective Indicators

Indicator Name	Core	Unit of Measure	Baseline (Dec. 31, 2013)	Cumulative Target Values				Data Source/ Methodology	Responsibility for Data Collection
				YR1 (Dec. 31, 2014)	YR2 (Dec. 31, 2015)	End Target (June 30, 2016)	Frequency		
Cumulative inflows into the DIF equivalent to 2.5% of insured deposits since January 1, 2014	☐	%	0.00	1.25% of the insured deposit level of December 31, 2013	2.0% of the insured deposit level of December 31, 2013	2.5% of the insured deposit level of December 31, 2013	Semi-annual	Project reports	DIA
DIA performing its legally mandated technical functions in any future bank failures in which DIF resources are utilized	☐	Yes/No	No	Yes	Yes	Yes	Semi-annual	Project reports	DIA

Intermediate Results Indicators

Indicator Name	Core	Unit of Measure	Baseline (Dec. 31, 2013)	Cumulative Target Values			Frequency	Data Source/ Methodology	Responsibility for Data Collection
				YR1 (Dec. 31, 2014)	YR2 (Dec. 31, 2015)	End Target (June 30, 2016)			
Premium rate	☐	%	0.4%	0.6%	0.6%	0.4%[14]	Annual	Verification Protocol 1.1, 1.2, and 1.3	DIA
Stand-by funding available for DIF	☐	Amount (EUR)	0	200m	50m	0	Annual	Verification Protocol 2.1 and 2.2	DIA
Number of independent Managing Board members	☐	Number	0	1	3	3	Annual	Verification Protocol 3.1 and 3.2	DIA
Financial stability committee meetings	☐	Number	0	2	6	8	Semi-annual	Verification Protocol 4.1 and 4.4	DIA
Sharing of NBS risk information on problematic banks with DIA	☐	Yes/No	No	Yes	Yes	Yes	Semi-annual	Verification Protocol 4.2 and 4.3	DIA
Sharing of NBS supervision conclusions on problematic banks with DIA	☐	Yes/No	No	Yes	Yes	Yes	Semi-annual	Verification Protocol 4.2 and 4.3	DIA
Cumulative value recovered from bank bankruptcies since February 1, 2014	☐	Amount (EUR)	0.00	20m	110m	110m	Semi-annual	Verification Protocol 5.1, 5.2 and 5.3	DIA
Information collected by the MoF on state-owned banks	☐	Yes/No	No	Yes	Yes	Yes	Annual	Verification Protocol 6.2 and 6.3	DIA

[14] The baseline and end target are the same as the premium increase of 0.2% will be in place only for 2014 and 2015

Project Development Objective Indicators	
Indicator Name	Description (indicator definition etc.)
Cumulative inflows into the Deposit Insurance Fund equivalent to 2.5 percent insured deposits since January 1, 2014	This indicator is a measure of the achievement of the target fund size for the Deposit Insurance Fund based on the assumptions and analysis in the PAD. It assumes an insured deposit level of EUR11.55 billion, which is the level as of December 31, 2013.
DIA performing its legally mandated technical functions in any future bank failures in which DIF resources are utilized	This is a measure of the DIA having the capacity to meet the technical functions that are defined in the Serbian legal framework in the case of a bank failure in which DIF resources are utilized.

Intermediate Results Indicators	
Indicator Name	Description (indicator definition etc.)
Premium Rate	Increasing the premium rate in 2014 and 2016 to increase the level of funding available in the DIF (DLI 1.1, 1.2 and 1.3)
Stand-by funding available for DIF	Putting in place stand-by funding for the DIF (DLI 2.1 and 2.2)
Number of Independent Board Members	Altering the composition of the Board of the DIA to improve independence (DLI 3.1 and 3.2)
Financial stability committee meetings	Meetings that include the NBS Governor, the Minister of Finance and the Managing Director of the DIA (a so called "Financial Stability Committee") to discuss any problematic banks should be held on a quarterly basis to strengthen the coordination between the three financial safety net providers. (DLI 4.1 and 4.4)
Sharing of NBS risk information with DIA	Providing the DIA with the necessary risk information (DLI 4.2 and 4.3)
Sharing of NBS Supervision Conclusions on Problematic Banks with DIA	Providing the DIA with the necessary information on problematic banks (DLI 4.2 and 4.3)
Cumulative value recovered from bank bankruptcies since February 1, 2014	Improving the performance of the recoveries process (DLI 5.1, 5.2 and 5.3)
Information Collected by the MoF on state-owned Banks.	Improving the quality of information collected on state-owned Banks (DLI 6.2 and 6.3)

ANNEX 2: DETAILED PROJECT DESCRIPTION

REPUBLIC OF SERBIA: Deposit Insurance Strengthening Project

Background on the Deposit Insurance Agency (DIA) and the Deposit Insurance Fund (DIF)

1. **The Deposit Insurance Agency (DIA) of Serbia was established in 2005 to provide deposit insurance, protect depositors, and preserve financial stability[15].** The Agency operates primarily under the Deposit Insurance Agency Law, the Deposit Insurance Law, and the Law on the Assumption of Assets and Liabilities[16], which outline the functions of the institution. The DIA primarily provides 30 member banks with a coverage limit of EUR50,000 per depositor per institution in the case of a bank failure through depositor reimbursement or other resolution tools that are chosen on a least-cost basis. The DIA has a "loss minimizer" mandate and utilizes several resolution tools that are available to it based on the legal framework that aims to minimize the cost of a bank failure. These resolution tools include the ability to facilitate a merger with another bank (a purchase and assumption transaction) with financial assistance from the Deposit Insurance Agency and the establishment of a bridge bank that acquires the assets of a failed bank with the aim to facilitate a future sale.

2. **The financial assets for facilitating the resolution of a failed bank are held within the Deposit Insurance Fund (DIF).** According to the Deposit Insurance Law, the Deposit Insurance Agency shall establish a special fund called the Deposit Insurance Fund that shall be financed by "deposit insurance premiums paid by banks, revenues from investments of the Deposit Insurance Fund's assets, the Agency's claims recovered from the bankruptcy or liquidation estates of banks on the basis of the insured deposits, sale of a bridge bank, recovery of claims on the basis of initial capital from the bankruptcy or liquidation estates of bridge banks, borrowings, grants, and funds from the budget of the Republic of Serbia."

3. **Premiums that are charged to banks have been the largest source of revenue for the DIF**. The Deposit Insurance Agency currently charges 0.4 percent of insured deposits to each of the 30 banks operating in Serbia. Until September 2012, the DIF had EUR211 million in assets (see Figure 1). From 2010 to 2012, the inflows to the DIF from collected premiums were on average EUR39 million per year, and for 2013 were EUR46 million. Other inflows to the DIF (mainly interest on deposits and securities, and proceeds for bankruptcy estates of bankrupt banks) have amounted to roughly EUR1 million on average from 2010 to 2013.

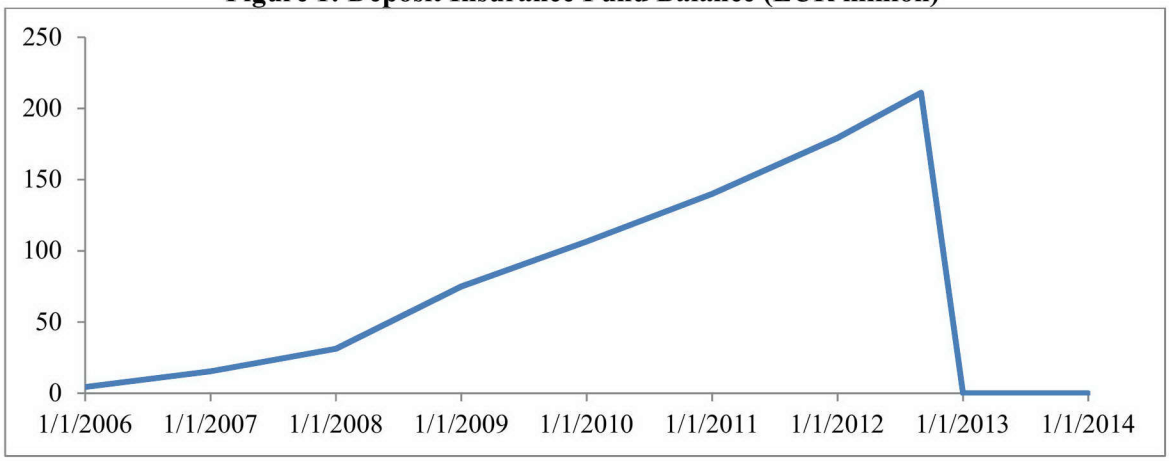
4. **The Deposit Insurance Fund (DIF) was depleted by the resolution of Agrobanka in 2012.** The failure of Agrobanka in 2012 utilized the full EUR211 million in the Deposit Insurance Fund and left the DIF with further liabilities of EUR34.1 million. The subsequent failure of two additional banks, RBV in 2012 and PBB in 2013, were resolved via the issuance of

[15] The Serbian DIA is the legal successor of the Agency for Deposit Insurance, Bank Rehabilitation, Bankruptcy and Liquidation that was established in 1989.

[16] There are also references to its functions in the Law on Bank and the Law on Bankruptcy and Liquidation of Banks.

government bonds as the DIF had been depleted. All three of these transactions involved a P&A with Postanska bank with external financial support (which, in the case of Agrobanka, was a combination of financial resources from the DIF and government bonds, and, in the case of RBV and PBB, involved only government bonds).

Figure 1: Deposit Insurance Fund Balance (EUR million)



Source: Deposit Insurance Fund of Serbia

Financing the DIF with sufficient resources (from external creditors, government budget, bank premiums, recoveries, and investments) to allow the Deposit Insurance Agency to meet its deposit insurance and bank resolution obligations and serve as a core part of financial sector safety net..

5. **This section identifies the level of financing that is required for the DIF to allow the DIA to meet its deposit insurance and bank resolution obligations.** The DIF must be restored to a level that provides sustainable and credible protection against future bank failures in normal times. Deposit insurance fund target reserve ratios around the world vary (see Table 1) and are based on different bank risk profiles in jurisdictions and the methodologies used to determine fund reserve targets. Best international practices, however, indicate that whatever approach is taken, an optimal fund target must ensure that depositors can be reimbursed promptly and balance the potential losses that each deposit insurer is exposed to with the ability of its member banks to fund the system in normal times. A number of approaches can be used to determine a target fund size such as methodologies incorporating historical and actuarial prediction techniques; risk assessment/credit portfolio models; and "bottom-up" size based approaches (see Box 2).

6. **The DIA's current risk assessment/exposure methodology yields a fund reserve target ratio of approximately 3.0 percent of insured deposits.** The DIA's total bank risk indicator (TBRI) model is based on data collected directly from the DIA's member banks including measures of capital adequacy, earnings and liquidity weighted by insured deposit exposure. The model classifies banks into four categories: Category I (normal operations); Category II (medium risk); Category III (early warning signs); and Category IV (official receivership). According to this approach the minimum fund target sufficient to cover expected potential liabilities of banks in categories III and IV is 3.0 percent of insured deposits or EUR346 million at end-2013.

Box 2: Overview of Approaches to Developing Deposit Insurance Target Reserve Fund

The most common approach to developing a target reserve ratio for a deposit insurance fund is to consider the country's historical experience with bank failures and associated losses. This approach is utilized in a number of countries including Brazil and the Bahamas. The advantage is that it is relatively straightforward, understandable and relies on existing information. A shortcoming is that the past may not be a good guide to the future and it does not take into account the current risk profile of banks and other information, which may be of use in assessing potential losses.

The risk assessment or credit portfolio approach is a more analytical method to determine a suitable reserve ratio and is used, for example, in Russia, Singapore, Canada, and the United States. Under these systems the fund reserve is viewed as being subject to a portfolio of credit risks similar to bank loan portfolio. The portfolio consists of individual exposures to insured banks, each of which has the potential of causing a loss to the fund. In most cases there will be a relatively high probability of small losses and a lower probability of very large losses.

Another methodology used is a "rule of thumb" or "size-based" approach whereby the target reserve fund is selected to cover the cumulative losses of a significant number of small bank failures and at least one medium-sized bank. This approach is the most appropriate in Serbia due to the limited history of bank failures and the staffing and technical capacity of the DIA.

7. **A "bottom-up or sized based" approach to establishing a fund target ratio indicates that a fund of about 2.5 percent of the insured deposits would be reasonable.** At 2.5 percent of the insured deposits (EUR289 million at end-2013), the target fund would be approximately sufficient to cover the cumulative insured deposit amount of the 10 smallest (out of a total of 30) banks in Serbia or the total insured deposit amount of the 11th largest bank. Although a larger sized fund may be desirable, as increasing the fund target to 5.0 percent of the insured deposits at end-2013 (EUR578) would cover the cumulative insured deposit amount of the 13 smallest banks or the total insured deposit amount of the 5th largest bank, achieving that level in the near-term would not be feasible.

8. **Once an acceptable fund target size is determined there are two primary sources of revenue that can be utilized to achieve the target – premiums from banks and government contributions.** The Government of Serbia and the Deposit Insurance Agency have determined that they would like to achieve a 2.5 percent target ratio in the three years from 2014 to 2016. This is an aggressive target in such a short period as one simple projection indicates that it would take the DIA seven years to accumulate a target fund of 2.5 percent of total insured deposits with the current premium level of 0.4 percent of insured deposits and assuming insured deposit growth of 4 percent per annum and no additional bank failures. Achieving the 2.5 percent target ratio would thus require an increase in the premiums paid by the banks either through an increase in the regular premium or the implementation of an extraordinary premium. In addition, it would require a significant contribution from the government, which in this case would be financed through the World Bank loan.

Table 1: Target Fund Reserve Ratios in Various Jurisdictions
(Percent of Insured Deposits)

Country	Coverage Ratio[2]	Country	Coverage Ratio[2]
Argentina	5.00%	Serbia	5.00%
Brazil	5.00%	Albania	5.00%
Canada	1.00%	USA	1.35%
Columbia	5.00%	Taiwan	2.00%
Hong Kong	0.25%	Kenya	19.00%
India	2.25%	Jordan	3.00%
Korea	1.00%	Jamaica	2.00%
Singapore	0.30%	Kazakhstan	5.00%
Russia	5.00%	EU (proposed)	1.50%
Average (excluding Kenya)		**2.90%**	

Source: International Association of Deposit Insurers

9. **A number of options exist in terms of increasing premium income.** The 0.4 percent annual premium rate in use presently is similar to a number of other South-East European nations and slightly higher than the average of 0.32 percent calculated from a sample of 21 countries (see Table 2), and thus increasing the regular premiums is not recommended. Rather the use of premium surcharges or "extraordinary premium increases" for a short period of time is more appropriate and numerous countries have instituted this type of premium increase within their legal framework for deposit insurance. For example, a special premium may be assessed on insured institutions when the deposit insurance fund falls into deficit in Australia, Azerbaijan, Canada, Kazakhstan, Malaysia, Russia and Singapore. In addition, one could also institute a differentiated premium based on the risk-profile of banks as this has also been instituted in many countries, but this is not recommended in Serbia at this time due to the complexity of instituting this type of system.

10. **To reach the appropriate target fund level of 2.5 percent of the insured deposits by end-2016, premiums should be increased for all member banks to 0.6 percent per annum (total including the regular and extraordinary premium) in 2014 and 2015.** Figure 2 presents a scenario that assumes: (1) insured deposit growth of 4 percent per annum over the five-year forecast period; (2) EUR144.23 million financing by the government in 2014 and 2015; (3) regular premiums of 0.4 percent of insured deposits; (4) implementation of an extraordinary premium in 2014 and 2015 of 0.2 percent; and (5) no additional bank failures that result in payments from the DIF. This scenario achieves the target fund size in mid-2016.

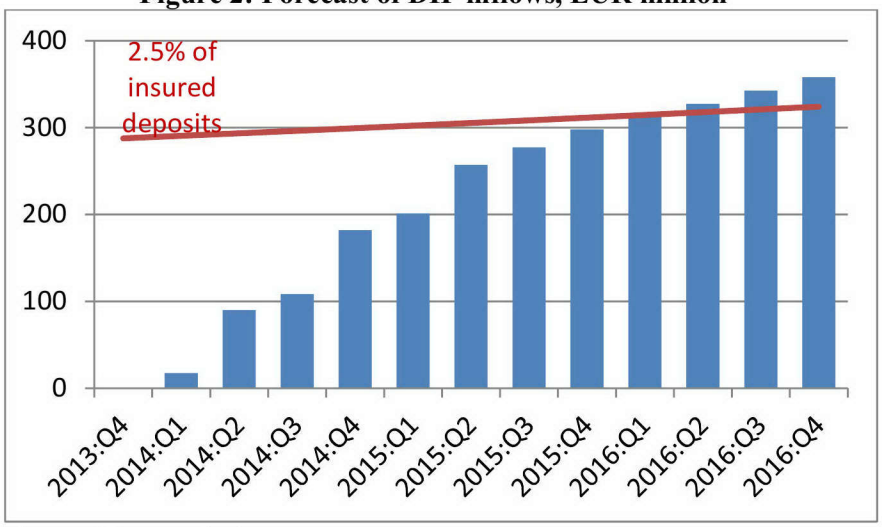
Table 2: Maximum Premium Rates (% of Insured Deposits) in Various Countries

Country	Premium range[2]	Country	Premium range[2]
Argentina	0.15-0.30%	Serbia	0.40%
Brazil	0.0125%	Albania	0.40-0.50%
Canada	0.028-0.22 %	Croatia	0.50-2.20%
Germany	0.02%	Mexico	0.40%
Hong Kong	0.02—0.05%	Japan	0.15%
India	0.10%	Russia	0.40%
Jordan	0.25%	Taiwan	0.05 – 0.15%
USA	0.025 – 0.45%	Romania	0.50%
Turkey	0.011 – 0..20%	Hungary	0.30-2.0%
Average	**0.32%**		

Source: International Association of Deposit Insurers

11. **The government should also put in place a stand-by facility or government guarantee that will ensure that sufficient funds are available prior to the other funds becoming available to the DIF.** This is in line with international best practice in which a Deposit Insurance Fund has a mechanism for accessing funds quickly and without the need for parliamentary approval if the need arises. For 2014, the stand-by facility should be at least EUR200 million and in 2015 it should be at least EUR50 million to ensure that funds are readily available to the DIF to meet the short-term target fund size of 2.5 percent of insured deposits that has been established by the government.

Figure 2: Forecast of DIF inflows, EUR million[17]



Source: Team analysis

[17] Based on the assumptions outlined in paragraph 10

Ensuring that the Deposit Insurance Agency has the institutional capacity to manage the financial resources it has available.

12. **This section outlines key areas that need to be strengthened in the Deposit Insurance Agency of Serbia in order to manage the financial resources that it has available.** In order to assess the capacity of the Deposit Insurance Agency to manage the financial resources available and to identify specific areas where improvements are needed, an assessment of the Serbian Deposit Insurance Agency's compliance with the Core Principles of Deposit Insurance that were adopted by the International Association of Deposit Insurers (IADI) and Basel Committee on Banking Supervision was conducted as part of the preparation of the project. These 18 core principles encompass not just the activities of the DIA but the legal framework, approach, and actions of the entire safety net with respect to protecting insured depositors and contributing to financial stability.

13. **Based on the assessment completed, the Serbian DIA is not compliant with the core principles in four categories.** These four are: 1) governance, 2) information sharing between financial safety net providers; 3) recoveries; 4) and early detection and timely intervention and resolution. In addition to these four, the DIA was also not compliant with the core principle on funding since the deposit insurance fund that it manages has been depleted by the recent bank failures. The rest of this section provides background on each of these four areas in the context of the Serbian DIA and outlines the key areas that need strengthening.

Governance

14. **The Core Principle on Governance states a Deposit insurer should be "operationally independent, transparent, accountable and insulated from undue political and industry influence."** Based on the Serbian Deposit Insurance Agency Law, the Managing Board of the DIA is comprised of seven members: a Chairman (as proposed/appointed by the government); the Minister of Finance; the Minister of Economy; the Vice-Governor of the NBS responsible for bank supervision; a member proposed by the NBS; a member proposed by the Association of Banks; and member proposed/appointed by the government. Terms are limited to six years and members may only be removed for cause, but the Board members are usually replaced when a new government is formed and the ministers (who are on the Board) are changed.

15. **The Managing Board of the DIA's operational independence and accountability are limited due to the composition.** Half of the Board is represented by ex-officio members from the government or NBS. In addition the position held by the member from the Association of Banks could present potential conflicts of interest with respect to discussion of the risk profile of member banks and intervention actions. Although it is appropriate and consistent with best practices for the government to appoint representatives to the Managing Board, they should not be ex-officio members. In addition, in line with international best practices independent members from the private sector (although not currently employed by one of the banks) should also be included.

Information sharing between financial safety net providers

16. **The Core Principle on the "relationships with other safety-net participants" focuses on ensuring that a Deposit Insurance Agency has the necessary information from the banking supervisor to meet its mandate.** The principle states "that a framework should be in place for the close coordination and information sharing, on a routine basis as well as in relation to particular banks, among the deposit insurer and other financial system safety-net participants. Such information should be accurate and timely (subject to confidentiality when required). Information-sharing and coordination arrangements should be formalized."

17. **Information sharing and coordination agreements have been developed between the DIA, NBS, and MOF.** The MOU on Referring to the Direct Cooperation and Information Exchange Regarding Deposit Insurance addresses information sharing between the NBS, DIA and MOF and confidentiality provisions. The MOU entitled Agreement on Collaboration for the Maintenance of Financial Stability in the Republic of Serbia identifies the key issues and factors in crisis management for the above-mentioned parties. A key element is the creation of a Financial Stability Council (FSC) that is supposed to plan and decide how to resolve failing banks and to deal with ongoing and potential financial sector stability issues. The FSC includes the Governor of the NBS, the Minister of Finance, and the Managing Director of the Deposit Insurance Agency.

18. **In practice the MOUs and other mechanisms put in place do not provide the necessary level of information flow and coordination to support the DIA.** The results of regular supervisory examinations and internal risk analysis by the NBS are not provided to the DIA. While the DIA receives some data on banks' capital adequacy ratios, liquidity, and cash flow, it does not receive stress testing information or data about the quality of banks' assets (such as the level of non-performing loans) and must collect additional data for use in its risk assessment model. The FSC also does not meet regularly nor does it conduct regular contingency planning. Moreover, the terms for the exchange of information are overly qualified (e.g. "in due time" and which "could be useful to the other party"), and does not ensure that the necessary information is provided to the DIA in a timely manner. The information received on depositor liabilities also does not include more accurate information on the net amount of insured deposits held by individual depositors (after set-off),which is needed to improve the timeliness of the reimbursement process.

19. **Good practices in information sharing and coordination used in other countries should be adopted where appropriate.** In Canada, the United States and Poland both the statutes of the supervisory authority and deposit insurer require each organization to make available all information requested from each party, subject to confidentiality. The Canadian authorities, for example, have in place statutory requirements for information sharing and have developed a *Guide to Intervention for Federal Financial Institutions* -- which sets out clearly the roles and responsibilities of the agencies during each early warning and intervention stage for a troubled institution. The heads of the supervisory authority and deposit insurer have also developed a strategic alliance agreement, which provides more specific details on information and sharing processes for each agency. These arrangements are backed–up by coordinating committees, which meet regularly and report to each other on their activities.

20. **In line with international best practices, the Serbian DIA should receive more information in advance from the NBS in order to allow it to better anticipate and plan for failures.** The DIA should receive more information in advance from the NBS about banks that are in financial difficulty or expected to be in financial difficulty (e.g. regular reports on the risk profile of member banks and comprehensive data on asset quality, provisions, large exposures and stress tests from supervision reports). This would enable the DIA to perform a least cost evaluation and undertake earlier preparation for depositor reimbursement or the use of other resolution tools.

Recoveries

21. **The Core Principle on Recoveries states that the "management of the assets of the failed bank and the recovery process (by the deposit insurer or other party carrying out this role) should be guided by commercial considerations and their economic merits."** In addition, if the deposit insurer plays a role in the recovery process, its role is clearly defined in law or regulation and the deposit insurer maximizes recoveries to the extent that it can from the failed bank on a commercial or economic basis.

22. **The Serbian Deposit Insurance Agency serves as the bankruptcy administrator for bank bankruptcy cases, and as collector for government claims based on bad assets carved out of banks undergoing sale, restructuring or transfer.** The Deposit Insurance Agency is currently overseeing the liquidation of 18 ongoing bank bankruptcies. Most of the value of these assets is associated with the four largest public banks that were privatized and placed into liquidation in early 2002 (Beogradska, Beobanka, Investbank, and Jugobanka), which combined constituted about 80 percent of banking assets in the Serbian market at the time. The total actual book value of the assets for these 18 banks is estimated to be EUR3.5 billion. However, over 90 percent of the total assets under bank bankruptcy proceedings pertain to debtors mostly subject to legal proceedings that preclude immediate recovery. These include claims by the bankrupt banks against state-owned enterprises in the privatization process and debtors in bankruptcy. However, the DIA will be the primary creditor for any future bank resolutions in which the DIA contributes funds. During the past few years, the asset recovery process has contributed about EUR35 million to the Serbian budget.

23. **Although there are significant hurdles in closing the bankruptcy cases and recovering assets from the current 18 cases, there are opportunities to improve and speed up the auction process in order to maximize the recovery of assets managed by the Deposit Insurance Agency.** Bankruptcy auctions are the primary mode of recovery for the most valuable assets that are part of the portfolio of assets to be recovered (primarily fixed assets and real estate). However, the auction methodology that has been adopted by the DIA, in some cases, limits the potential for a successful auction. Improving this methodology could improve the results from the recovery of assets managed by the DIA.

24. **Improving the recovery process is not only important for realizing as much value from the current assets from bankrupt banks, but more importantly for the DIA to improve its capacity if another bank failure occurs in the future.** Although the DIA is not a creditor in the current bankruptcy cases, improvements in the recoveries process and the framework for auctions will ensure that they have a sound time-bound strategic framework for

completing the bankruptcy process in the future when funds from the DIF are utilized for a resolution.

Early detection and timely intervention and resolution

25. **The Core Principle on early detection and timely intervention and resolution states that a framework should exist that "provides for the early detection and timely intervention and resolution of troubled banks."** Although this principle should apply to all banks, the three recent failures were banks in which the state had the largest ownership stake. Considering this, there is a need to validate the information available for some of the smaller state-owned banks in order to ensure early detection and timely intervention of these banks in the near-term.

Project Design

26. **In addition to the project description provided in the main text, this section gives a detailed description of the project components.**

Component 1: Strengthen the financial capacity of the DIA (EUR144.23 million)

27. **This component finances the DIF with EUR144.23 million.** In addition to confirmation of the financing the DIF, disbursements require the achievement of DLIs in six categories (Figure 3). Each DLI is given a Euro value, with the total amount for achieving all of the DLIs equaling the amount available in this component. Time frames for the achievement of the DLIs have been developed in 2014, 2015 and 2016, but they are indicative and disbursements can occur at any point when the DLIs have been achieved and the eligible expenditure corresponding to the financing of the DIF has been completed.

28. **The disbursement linked indicators are summarized in the subsequent paragraphs.** The choice of the DLIs was based on the areas that the IADI Core Principles Assessment identified as weaknesses in the Serbian Deposit Insurance System.

Disbursement Linked Indicator #1 – Premiums

29. **The target fund size of 2.5 percent of the insured deposits can be met through the implementation of an extraordinary premium increase and the financing of the DIF by the government of EUR144.23 million.** This extraordinary increase will need to be at least 0.2 percent of insured deposits in 2014 and 2015 in order to meet the agreed target fund level of 2.5 percent of the insured deposits in three years (in addition to the regular 0.4 percent premiums that are currently charged). The DLIs for the three disbursement periods are outlined in Table 3 and will ensure that the target fund size of 2.5 percent of insured deposits will be met during 2014-2016.

Table 3: DLIs for Premiums

	2014 Target Date = November, 2014	2015 Target Date = May, 2015	2016 Target Date = May, 2016
DLI #1: Premiums	DLI#1.1: Premiums equal to 0.15 percent of insured deposits for each of the first two quarters of 2014 are collected for all banks that are licensed in the Republic of Serbia at the time of collection (insured deposit level is based on average of previous quarter) by November 30, 2014	DLI#1.2: Premiums equal to 0.15 percent of insured deposits for each quarter of the calendar year of 2014 are collected for all banks that are licensed in the Republic of Serbia at the time of collection (insured deposit level is based on average of previous quarter) by May 31, 2015	DLI#1.3: Premiums equal to 0.15 percent of insured deposits for each quarter of calendar years 2014 and 2015 are collected for all banks that are licensed in the Republic of Serbia at the time of collection (insured deposit level is based on average of previous quarter) by May 31, 2016

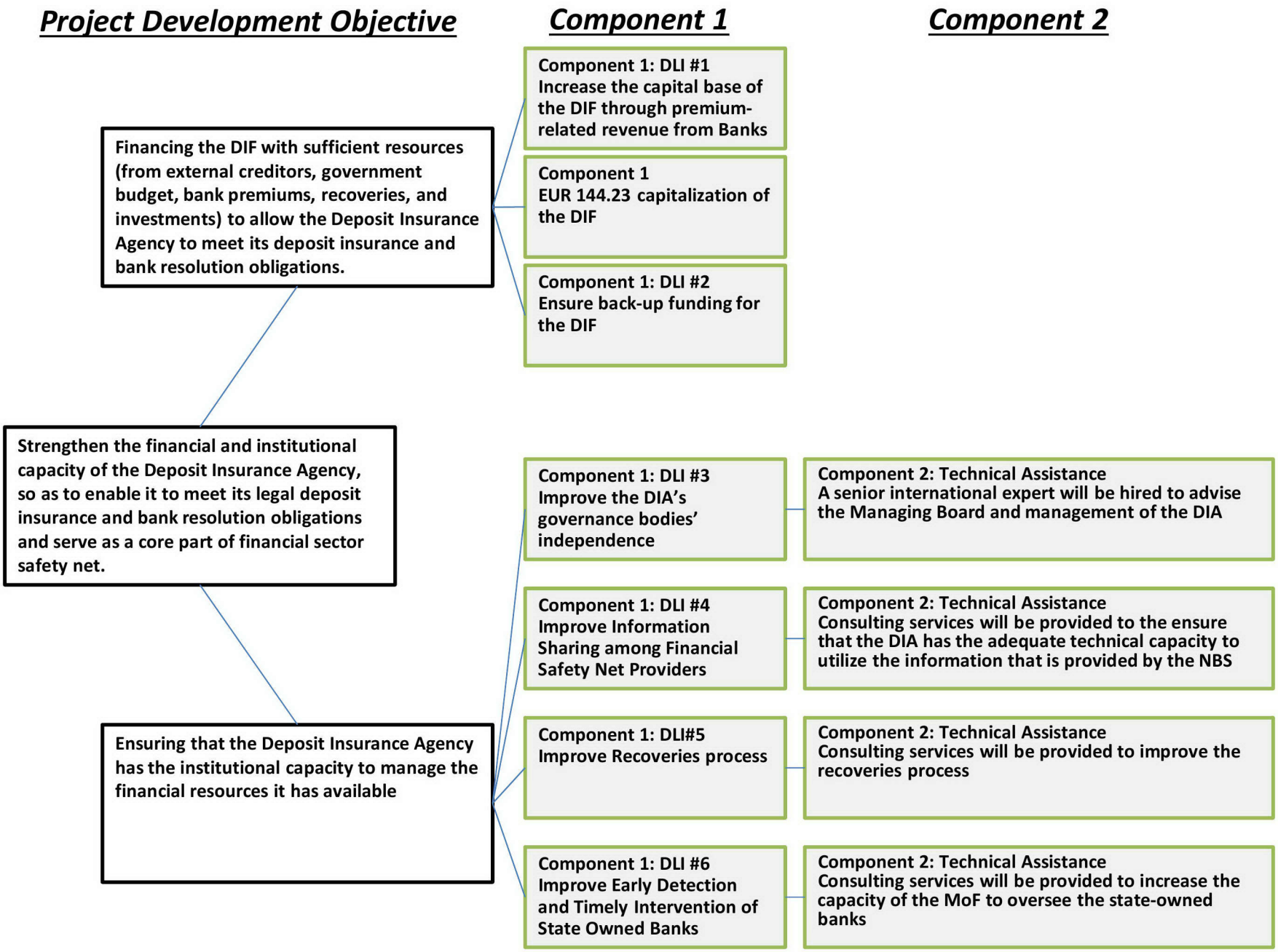
Disbursement Linked Indicator #2 – Back-up funding for the DIF

30. **The second set of DLIs will ensure that the DIF has back-up funding in place in case it is necessary** (see Table 4) As mentioned earlier, best practice for Deposit Insurance Schemes includes having a back-up facility that ensures that funds can be accessed without parliamentary approval during a time of banking instability. Thus, the second set of DLI ensures that the government puts in place a guarantee or stand-by facility of at least EUR200 million in 2014 and EUR50 million in 2015 (the decrease is due to the increasing financial flows into the DIF during 2014 and thus decreasing the need for back-up funding).

Table 4: DLIs for Back-up funding

	2014 Target Date = June, 2014	2015 Target Date = January, 2015	2016 Target Date
DLI #2: Back-up funding	DLI#2.1: the government has back-up funding in the budget for financial stability (which includes the DIF) of at least EUR200m for 2014	DLI#2.2: the government has back-up funding in the budget for financial stability (which includes the DIF) of at least EUR50m for 2015	N/A

Figure 3: Outline of Serbian Deposit Insurance Agency Strengthening Project



Disbursement Linked Indicator #3 – Governance

31. **The third set of DLIs will address the issues outlined earlier related to the independence of the Governance of the Deposit Insurance Agency.** DLIs have been designed to put in place three Independent Directors over the course of two years. In addition, the composition of the Managing Board will also be changed to give the Independent Directors the majority on the Board (see Table 5). Independence will be defined to (1) exclude individuals who: (i) primarily derive their income directly from the government; (ii) work for the NBS, (iii) work for agencies founded by the Republic of Serbia; (iii) work for public enterprises; (iv) work for a bank that operates in Serbia, or are members of the board of such banks; or (v) are members and/or employees and/or officers of any professional banking association, or of an entity related to it; and (2) not to exclude individuals who carry out academic or research functions (in any capacity) for research institutions or universities owned or funded by the Republic of Serbia. Additionally, the independent board members should have the minimum following qualifications: at least eight years of prior relevant experience in the financial sector, finance, law or auditing, or academia and research institutes (including those that are publically funded).

Table 5: DLIs for Governance

	2014 Target Date	2015 Target Date = January, 2015	2016 Target Date = January, 2016
DLI #3: Governance	N/A	DLI#3.1: One independent board member is appointed and serving as a member of the DIA's managing board	DLI#3.2: The DIA's managing board is constituted by at least three serving independent board members that make up a majority of the board and no government ministers

Disbursement Linked Indicator #4 – Information Sharing between Financial Safety Net Providers

32. **In order to strengthen the coordination between the three financial safety net providers, DLIs (see Table 6) will target the sharing of key data between the NBS and the DIA.** Specifically, data will be shared on: i) the risk profile of all problematic banks in Serbia as computed by the NBS; (ii) conclusion of supervision reports for banks which are considered problematic; and (iii) details on all enforcement actions and compliance related to problematic banks. In addition, the DLIs will require that meetings are held on a quarterly basis with the NBS Governor, the Minister of Finance and the Managing Director of the DIA to discuss any problematic banks (the so called "Financial Stability Committee").

Table 6: DLIs for Information Sharing

	2014 Target Date = July, 2014	2015 Target Date = January, 2015	2016 Target Date = January, 2016
DLI #4: Information Sharing between Financial Safety Net Providers	DLI#4.1: The Government's Financial Stability Committee holds two quarterly meetings since January 1, 2014	DLI#4.2: The NBS has shared with the DIA the following data for at least one calendar quarter starting on January 1, 2014: (i) the risk profile of all problematic banks as computed by the NBS; (ii) conclusion of supervision reports for banks which are considered problematic; and (iii) details on all enforcement actions and compliance related to problematic banks	DLI#4.3.: The DIA has shared with the Project Implementing Entity the following data for at least five calendar quarters starting on January 1, 2014: (i) the risk profile of all problematic banks as computed by the NBS; (ii) conclusion of supervision reports for banks which are considered problematic; and (iii) details on all enforcement actions and compliance related to problematic banks DLI#4.4.: The Government's Financial Stability Committee meets on a quarterly basis for at least eight calendar quarters between 2014 and 2016

Disbursement Linked Indicator #5 – Recoveries

33. **The Deposit Insurance Agency's mandate also includes collecting receivables from bank bankruptcies and liquidations as outlined earlier.** The DLIs related to recoveries will speed up the recoveries process for the assets from banks in bankruptcy that the DIA currently manages (see Table 7). The current level of recoveries over the past several years has averaged EUR40 million per year. The targets for recoveries will be a 25 percent increase in 2014 (EUR50 million) and 50 percent increase in 2015 (EUR60 million).

Table 7: DLIs for Recoveries

	2014 Target Date = August, 2014	2015 Target Date = January, 2015	2016 Target Date = January, 2016
DLI #5 Recoveries	DLI#5.1: EUR20m recovered from bank bankruptcies and deposited into a Systemically Important Bank(cumulatively since February 1, 2014)	DLI #5.2: EUR50m recovered from bank bankruptcies and deposited into a Systemically Important Bank (cumulative since February 1, 2014)	DLI#5.3: EUR110m recovered from bank bankruptcies and deposited into a Systemically Important Bank (cumulative since February 1, 2014)

Disbursement Linked Indicator #6 - Early detection and timely intervention and resolution

34. **A critical element of a Deposit Insurance System is the early detection of problematic banks.** Although this applies to all banks, considering that the insolvency of the DIF resulted from the failure of three banks in which the state had an ownership stake, there are concerns about the accuracy of the information on some of the smaller state-owned banks that should be addressed in the near-term. Thus, the DLIs will target the collection of accurate information on the state-owned banks by the owner (the government) and the sharing of this information with the Deposit Insurance Agency (see Table 8 below)

Table 8: DLIs for Early Detection and Timely Intervention and Resolution

	2014 Target Date = August, 2014	2015 Target Date = January, 2015	2016 Target Date = January, 2015
DLI #6 Early detection and timely intervention and resolution (of state-owned banks)	DLI#6.1: All banks with at least 20 percent state ownership (and not in the privatization process) conduct an audit and provide the information to the Ministry of Finance	DLI #6.2: The government has collected information on each bank with at least 20 percent state ownership for at least one calendar year since January 1, 2014, including at least: (i) detailed financial information; (ii) information on asset quality; and (iii) actions needed to meet supervision standards	DLI#6.3: The government has collected information on each bank with at least 20 percent state ownership for at least two calendar years since January 1, 2014 including at least: (i) detailed financial information; (ii) information on asset quality; and (iii) actions needed to meet supervision standards

35. **The full set of Disbursement Linked Indicators is included in Table 9.** The table includes not only the DLIs, but also the Euro amount associated with each DLI.

Component 2: Strengthen the institutional capacity of the DIA (EUR0.71 million)

36. **This component will finance technical assistance in critical areas that are needed to achieve the DLIs (Component 2a).** Figure 3 outlines TA required to achieve the DLIs in four of the six categories. The TA will involve only consulting services and will focus on:

- *Governance (EUR90,000):* A senior international expert will be hired to advise the management of the DIA. Advice will be provided on developing an operational manual for the Managing Board of the DIA and ensuring that it has the capacity to meet its legally mandated requirements. The Advisor will also help develop a staffing strategy for the DIA. In addition, the Advisor will assist the Managing Board in ensuring that the DLIs are met and identify any areas that require early intervention.
- *Information sharing between safety net providers (EUR130,000):* Consulting services will be provided to ensure that the DIA has the adequate technical capacity and staffing to utilize the information that it is provided from the NBS. This task will be performed by three local consultants with experience in bank supervision, auditing, or financial analysis. The consultants will develop procedures on how the data provided by NBS is utilized in planning and decision making.
- *Recoveries (EUR 240,000):* Consulting services will be provided to develop a time-bound strategy and implement it over the course of two years. For this purpose one local lawyer will be hired along with four local consultants, all with experience in recoveries. The primary goal will be acceleration and scaling up of recoveries in the various bankruptcies in which the DIA is the administrator.
- *Oversight of state-owned banks (EUR205,000):* Consulting services will be provided to increase the capacity of the MoF to oversee the state-owned banks and improve the corporate governance framework. A local lawyer with experience in financial legislation, audits and corporate governance will be engaged. Also, three local consultants with experience in audits and financial analysis will be engaged to develop procedures for monitoring state-owned banks and to analyze the information provided to ensure informed decision making in the MoF.

37. **This component will also finance TA to support the project implementing entity (Component 2b)**. EUR41,750 will be utilized to support the monitoring and evaluation functions related to the DLIs, as well as other critical functions to strengthen the project implementing entity related to financial management and procurement.

Table 9: Disbursement Linked Indicators for the Serbia Deposit Insurance Strengthening Project

Disbursement Linked Indicator		*EUR*
DLI 1. Increase the capital base of the DIA through increased premium-related revenue from banks	DLI#1.1: Premiums equal to 0.15% of insured deposits for each of the first two quarters of 2014 are collected for all banks that are licensed in the Republic of Serbia at the time of collection (insured deposit level is based on average of previous quarter) by November 30, 2014	DLI#1.1: 21,800,000
	DLI#1.2: Premiums equal to 0.15% of insured deposits for each quarter of the calendar year of 2014 are collected for all banks that are licensed in the Republic of Serbia at the time of collection (insured deposit level is based on average of previous quarter) by May 31, 2015	DLI#1.2: 21,800,000
	DLI#1.3: Premiums equal to 0.15% of insured deposits for each quarter of calendar years 2014 and 2015 are collected for all banks that are licensed in the Republic of Serbia at the time of collection (insured deposit level is based on average of previous quarter) by May 31, 2016	DLI#1.3: 7,270,000
DLI 2. Ensure back-up funding for the DIF	DLI#2.1: the government has back-up funding in the budget for financial stability (which includes the DIF) of at least EUR 200,000,000 for 2014, by November 30, 2014	DLI#2.1: 7,270,000
	DLI#2.2: the government has back-up funding in the budget for financial stability (which includes the DIF) of at least EUR 50,000,000 for 2015, by May 31, 2015	DLI#2.2: 3,630,000
DLI 3. Improve the DIA's governance bodies' independence	DLI#3.1: One independent board member (as independence criteria is defined in the Project Operations Manual) is appointed and serving as a member of the DIA's managing board	DLI# 3.1: 7,270,000
	DLI#3.2: The DIA's managing board is constituted by at least three serving independent board members (as independence criteria is defined in the Project Operations Manual) that make up a majority of the board and no Borrower's ministers	DLI# 3.2: 10,530,000

Disbursement Linked Indicator		*EUR*
DLI 4. Improve the DIA's ability to anticipate and respond to problematic banks	DLI#4.1.: The government's Financial Stability Committee meets on a quarterly basis for at least two calendar quarters starting on January 1, 2014	DLI#4.1: 3,630,000
	DLI#4.2: The NBS has shared with the DIA's the following data for at least one calendar quarter starting on January 1, 2014: (i) the risk profile of all the problematic banks as computed by the NBS; (ii) conclusion of supervision reports for banks which are considered problematic based on the current legal framework; and (iii) details on all enforcement actions and compliance related to problematic banks	DLI#4.2: 7,270,000
	DLI#4.3.: The NBS has shared with the DIA the following data for at least five calendar quarters starting on January 1, 2014: (i) the risk profile of all the problematic banks as computed by the NBS; (ii) conclusion of supervision reports for banks which are considered problematic based on the current legal framework; and (iii) details on all enforcement actions and compliance related to problematic banks	DLI#4.3: 3,630,000
	DLI#4.4.: The government's Financial Stability Committee meets on a quarterly basis for at least eight calendar quarters between 2014 and 2016	DLI#4.4: 2,910,000
DLI 5. Improve the DIA's asset recovery process	DLI#5.1: EUR 20,000,000 recovered from bank bankruptcies and deposited into a Systemically Important Bank(cumulatively since February 1, 2014)	DLI#5.1: 3,630,000
	DLI #5.2: EUR 50,000,000 Euros recovered from bank bankruptcies and deposited into a Systemically Important Bank (cumulative since February 1, 2014)	DLI#5.2: 3,630,000
	DLI#5.3: EUR 110,000,000 Euros recovered from bank bankruptcies and deposited into a Systemically Important Bank (cumulative since February 1, 2014)	DLI#5.3: 3,630,000
DLI 6. Ensure that the government and the DIA have adequate information on the state-owned banks	DLI#6.1: All banks with at least 20% state ownership (and not in the privatization process) conduct an audit and provide the information to the Ministry of Finance	DLI#6.1: 18,160,000
	DLI #6.2: The government has collected information on each bank with at least 20% state ownership for at least one calendar year since January 1, 2014, including at least: (i) detailed financial information; (ii) information on asset quality; and (iii) actions needed to meet supervision standards	DLI#6.2: 10,900,000
	DLI#6.3: The government has collected information on each bank with at least 20% state ownership for at least two calendar years since January 1, 2014 including at least: (i) detailed financial information; (ii) information on asset quality; and (iii) actions needed to meet supervision standards	DLI#6.3: 7,270,000
Total		€144,230,000

ANNEX 3: IMPLEMENTATION ARRANGEMENTS

REPUBLIC OF SERBIA: Deposit Insurance Strengthening Project

Project Institutional and Implementation Arrangements

1. **The DIA will serve as the Project Implementing Entity for both Components 1 and 2.** The institutional and implementation arrangements are relatively straight forward, as Component 1 has relatively few disbursements against a relatively small number of DLIs, and Component 2 involves a small number of consulting contracts. In order to facilitate the project, a Project Implementation Team (PIT) has been established in the DIA. The principal PIT activities will comprise: (i) verifying DLIs achievement for purposes of disbursement; (ii) reporting on the Bank advances that result in the financing of the DIF; (iii) managing TA procurement; and (iv) liaising with and reporting to the government and with the World Bank on project progress.

2. **The Borrower shall, at all times, ensure that, the Project Implementing Entity maintains** governance arrangements and a financial management system adequate to reflect the operations, resources and expenditures of the PIT, acceptable to the Bank.

Financial Management, Disbursements and Procurement

Financial Management and Disbursements

3. **Financial management risk.** The overall FM Risk is assessed to be moderate, after taking into account mitigation measures.

4. **Project Implementing Entity staffing**. The project will be implemented by the DIA through a Project Implementing Team that has the same staff that implemented the World Bank's Pensions Administration project which closed in 2012 (including the financial management officer and disbursement officer). Standard World Bank Terms of Reference for Financial Management Staff with detailed descriptions of duties will be used for the project. The PIT will be responsible for the project's financial management arrangements and the team in charge of the FM will perform tasks related to accounting, financial reporting, disbursement, ensuring application of internal controls related to financial management and work with the external auditors during the audit of financial statements.

5. **Planning and Budgeting.** There is sufficient capacity for planning and budgeting to manage project funds. Variances of actual versus budgeted figures will be monitored on a regular basis, appropriately analyzed and, based on the results, corrective actions will be taken.

6. **Accounting System**. The accounting policies and procedures are appropriate. Due to the small number of contracts and transactions under the project, excel files are deemed to be sufficient for maintaining accounting records. Accounting records will also include appropriate analytics of expenditures per contract and for each specific payment. The project will follow cash based accounting (cash based IPSAS), recording transactions when actual payment is done, rather than when they are incurred. Transactions will be accounted for within eight days after incurring. There will be appropriate back up of accounting records on external drives, as well as

appropriate security regulation with regard to access and editing rights of the financial information.

7. **Internal controls.** The existing system of internal controls within the project implementing entity will be used as the basis for internal controls and procedures. These procedures and controls to be applied in the project were described in the POM that was prepared prior to negotiations and which will be finalized by project effectiveness. Some of the key internal controls to be applied for the project include:

- appropriate authorization and approval of all purchases, relevant documentation, transactions of payments, etc.;
- segregation of duties as different persons are responsible for different phases of a transaction;
- reconciliations between project accounting records and other relevant sources of information (Client Connection, bank account statements etc.) should be performed at least monthly by the Finance Officer; and
- original documentation exists to support all project transactions.

8. **Financial Reporting.** Interim un-audited financial reports (IFRs) that will include financial information relating to the whole project (both Components 1 and 2) will be prepared for each calendar semester (January 1-June 30; July 1-December 31) and will be due 45 days after the end of each semester. The IFRs will be prepared in line with cash based IPSAS. The format of the IFRs is agreed to between the Bank and the Client and attached to the minutes of negotiation. The reporting currency will be EUR. The IFRs are intended to comprise the following reports:

a) Cash receipts and payments, including comparison of budgeted versus actual amounts;
b) Uses of funds by activity;
c) Designated Accounts statement;
d) Accounting policies and explanatory notes.

9. **External audit.** An annual audit of the project financial statements will be conducted by a private audit firm acceptable to the Bank and it will be extended to provide independent verification of achievement of DLIs in relation to Component 1. In addition, the audit will verify that any of the World Bank's financing for the DIF was utilized in line with the legal framework for deposit insurance and bank resolution. An entity audit of DIA will also be required for all calendar years from effectiveness to the project closing. The audit reports will be submitted to the Bank not later than six months after the end of the audited period. The audit of project financial statements will be funded by the project (Component 2), while the audit of the financial statements of the project implementing entity will be covered by their own resources. The audited financial statements of the project will be posted by the client on the DIA or government website, within two weeks of the audit report being issued by the auditor and accepted by the World Bank. The control environment within the NBS is considered acceptable.

10. **Action plan.** The following action will be implemented to enhance the financial management arrangements. This action will not represent a legal covenant.

Action	Deadline	Responsible
POM will be prepared that describes controls and procedures for the project	Project Effectiveness	DIA

11. **Financial management covenants.** The financial management covenants for the project will be as follows:

a) Maintaining adequate financial management system within, and adequate control environment within the NBS.
b) DIA will prepare interim un-audited financial reports (IFRs) for each calendar semester (January 1-June 30; July 1-December 31) and deliver to the Bank not later than 45 days after the end of the reporting semester.
c) Annual project and entity financial statements will be audited by a private audit firm acceptable to the Bank and such audit will be delivered to the Bank not later than six months after the end of the audited period.
d) In the event that in any given calendar year the DIF Assets become less than the sum of the Transfers to the DIF, the annual audit report shall confirm that the difference is justified to fulfill the DIA's deposit insurance and bank resolution obligations, in accordance with the applicable laws and regulations, notwithstanding any minor variations that may occur to due to DIF's investment policy.

12. **Flow of funds.** Two separate designated accounts in foreign currency will be opened for Components 1 and 2 within the NBS and will be administered as described further in the text.

Component 1: Strengthen the financial capacity of the DIA (EUR144.23 million)

13. **This component aims to finance the DIF.** With respect to withdrawals under this component, withdrawals from the Designated Account for this component shall be made for a respective DLI upon submission by the Borrower, through the Project Implementing Entity, of: (i) evidence satisfactory to the Bank that transfers to DIF have been made; and (ii) supporting documentation confirming the achievement of the respective DLI or DLIs.

14. **The Borrower may withdraw an amount not to exceed the equivalent of EUR54,490,000 as an advance under Component 1.** However, if the DLIs are not achieved (or only partially achieved), the Borrower will be required to refund the advance.

15. **For the purposes of withdrawals under this component**, the deposits (that are not to exceed the amount outlined above) will be transferred to the foreign currency account (EUR) administered by the DIA (the Designated Account for component 1) within the NBS that is opened and used solely for proceeds from the loan account. The deposits will then be transferred to DIF's foreign currency account, exclusively for the purposes of financing the DIF, within seven days after the advance from the Bank to the Designated Account. Each financing of the DIF will be confirmed to the Bank within 30 days of it occurring, through delivering appropriate documentation evidencing the financing of the DIF. Such documentation will include: bank account statement for the Designated Account showing the transfer to the NBS for deposit in the DIF account; bank account statement from the NBS showing the transfer, and corresponding credit, to the DIF account; letter from the NBS confirming the receipt of funds from the Designated Account, and the deposit of the equivalent amount into the DIF account.

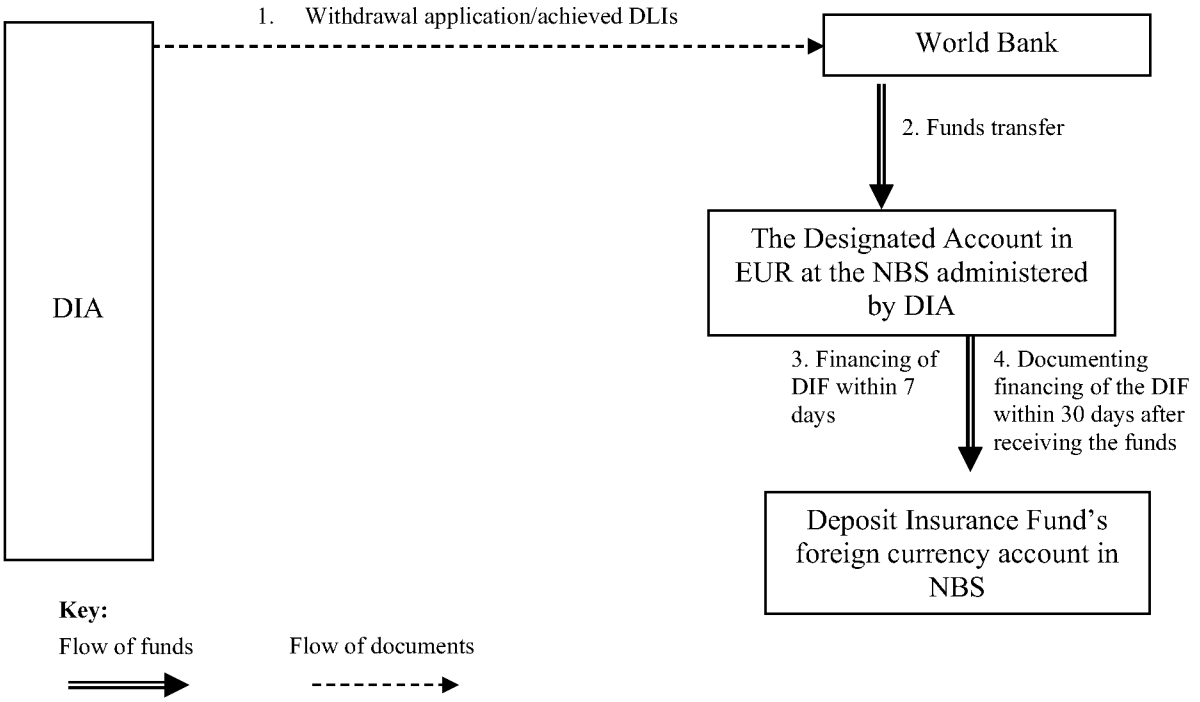
16. **Appropriate documentation evidencing the financing of the DIF and evidence of the achievement of DLIs will constitute the eligible expenditure.** Statements of Expenditures will be utilized to document eligible expenditures under this Component of the Project and the disbursement method will be advances. Each DLI is given a Euro value (see Table 9), and subsequent withdrawals up to the same amount as the value of the DLI met to the Designated Account will be made based on evidence of the financing of the DIF and verification of achievement of individual DLIs being met. The achievement of DLI 1 and DLI 2 is time-bound and may be reduced proportionately on a percentage basis corresponding to the respective degree of DLI achievement. The achievement of DLI 3, 4, 5, and 6 is not time bound (although Table 9 provides indicative time frames for their achievement) and thus a future withdrawal can only be given if the DLI is achieved fully along with a Statement of Expenditures confirming eligible expenditure for that amount.

17. **The Bank shall not be required to make further deposits into the Designated Account, for Component if:** (i) the Bank, at any time, is not satisfied that evidence and supporting documentation required as specified above and in the POM; or (ii) the Borrower shall have failed to furnish to the Bank, within the period of time specified, any of the audit reports required to be furnished to the Bank.

18. **If the Bank determines at any time that any payment out of the Designated Account was made for an expenditure, which is not an Eligible Expenditure, or was not justified by the evidence furnished to the Bank**, the Borrower shall, promptly upon notice from the Bank, provide such additional evidence as the Bank may request, or deposit into the Designated Account (or, if the Bank shall so request, refund to the Bank) an amount equal to the amount of such payment. Unless the Bank shall otherwise agree, no further deposit by the Bank into the Designated Account shall be made until the Borrower has provided such evidence or made such deposit or refund, as the case may be. Refunds to the Bank made shall be credited to the Loan Account for subsequent withdrawal or for cancellation in accordance with the provisions of the Loan Agreement.

19. **The control environment within the NBS is considered acceptable, based on the World Bank's assessment of the NBS and Treasury from 2011**. This also reflects consideration of the latest IMF Safeguards Assessment of the NBS from 2011. Any changes in the control and operating environment within the NBS will be monitored. The annual financial statements of the NBS for the year 2012 were audited by private audit firm (Deloitte, Serbia), and the auditors issued a clean/unmodified opinion on the financial statements identifying no issues. The audit opinion on 2011 financial statements was also clean.

Chart 1. Flow of Funds - Component 1



Component 2: Strengthen the institutional capacity of the DIA (EUR .71 million)

20. **This component will include technical assistance to the DIA,** primarily for consulting services aimed at assisting in achieving DLIs for component 1.

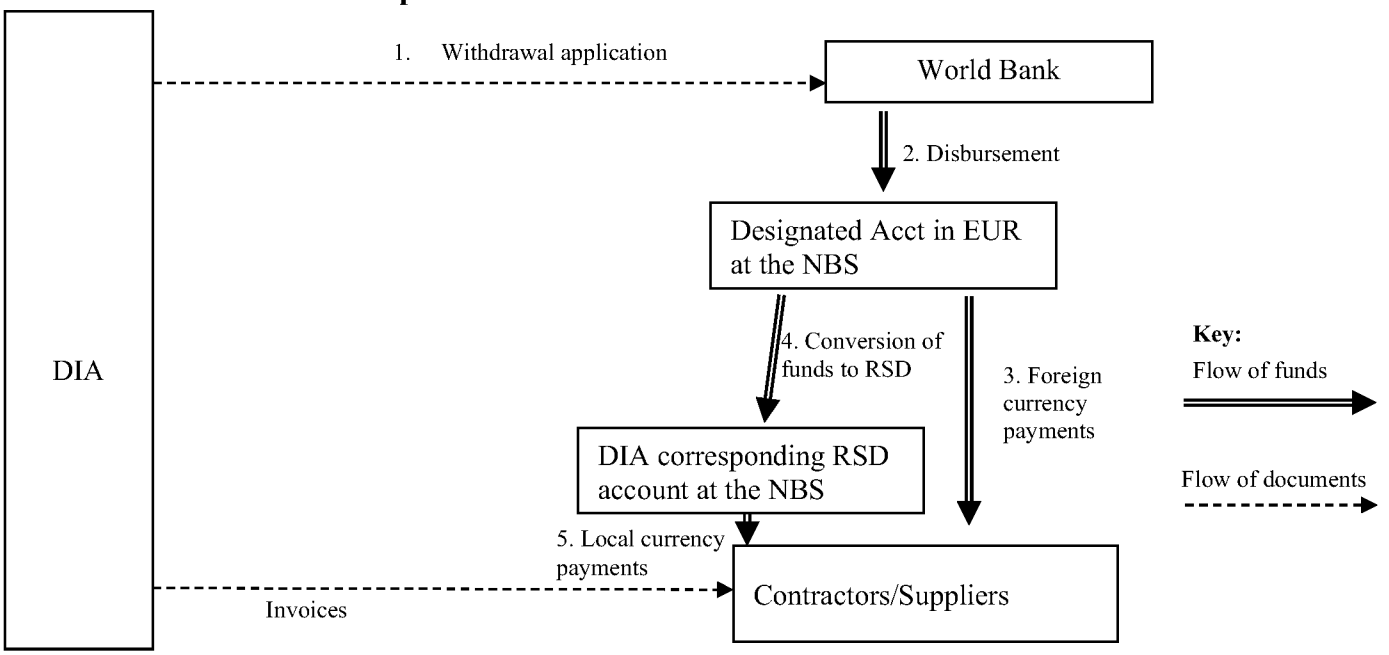
21. **Funds Flow and Disbursement Arrangements.** The designated account for Component 2 to which the funds will be withdrawn to/paid from will be opened in the NBS. It will be a foreign currency (EUR) account from which the funds from the World Bank will be withdrawn and will be used only for the purpose of inflows and outflows under this project's component. From that account, funds needed for payments in local currency will be transferred to a corresponding RSD account opened with the same purpose. Payments in foreign currency to contractors based abroad will be executed directly from the designated account.

22. **The DIA will be administering the Designated Account.** The project implementing entity will prepare withdrawal applications for the replenishment of the Designated Account, which will be signed by designated signatories (DIA management). Payments from the Designated Account will be executed by the means of payment orders. After all of the procedures with respect to the flow of documents and verifications and authorizations that are described in the Operations Manual are applied, a payment order signed by the designated signatories will be submitted to the bank where the Designated Account is opened for payment.

23. **The Ceiling for this Designated Account is set at EUR200,000.** Documentation requirements for replenishment would follow standard Bank procedures as described in

Disbursement Handbook. Monthly bank statements of the Designated Account, which have been reconciled, would accompany all replenishment requests.

Chart 2. Flow of Funds – Component 2



Procurement

24. **A capacity assessment of the procurement staff proposed to work in the project procurement implementation was conducted during negotiations.** Based on the assessment it was determined that the risk level in procurement was minimal.

24. **A POM was created according to the needs of the new project and submitted to the Bank in draft form at negotiations.** The POM included the description of the procurement procedures that apply under World Bank Guidelines. A WB procurement specialist or procurement accredited staff will carry out ongoing supervision under the loan. Also, s/he will participate in implementation support missions and site visits and provide ad hoc advice and support to the PIT, as required.

25. **Selection of Consultants.** Consultants will be hired by the project to support the services reflected in the procurement plan. Consulting firms will be selected using the following selection procedures: Quality- and Cost-Based Selection (QCBS); Quality-Based Selection (QBS); Selection under a Fixed Budget (FBS) and Least-Cost Selection (LCS). The Selection Based on the Consultants' Qualifications (CQS) method may be used in assignments below US$300,000 equivalent, officially declared emergencies and as such recognized by the Bank, and for standard tasks for which the need for issuing a Request for Proposal, and preparing and evaluating competitive proposals is not justified. With justification satisfactory to the Bank, sole source selection can be used for hiring both firms and individual consultants as described in paragraphs 5.1-5-6 of the Consultants' Guidelines. Contracts estimated to cost US$200,000 equivalent or more will be advertised internationally. Short lists of consultants for services estimated to cost

less than US$300,000 equivalent per contract may be composed entirely of national consultants in accordance with the provisions of paragraph 2.7 of the Bank's Consultant Guidelines.

26. **Operating Costs.** Operating costs of the PIT will be financed from the Loan proceeds and will include all expenses necessary to ensure proper implementation of the project, including inter-alia translation, interpretation, equipment maintenance and operations, travel costs (transportation, lodging and per diem). Procedures will be described in the POM.

27. **Procurement Plan.** For each contract to be financed by the IBRD Loan, the different procurement methods or consultant selection methods, estimated costs, prior review requirements, and timeframe will be agreed between the Borrower and the Bank Project team in the Procurement Plan. The Borrower has developed a preliminary procurement plan for Project implementation that was approved during negotiations. Upon the Project's approval, the procurement plan will be made available in the Project's database and on the Bank's external website. The procurement plan will be updated annually in agreement with the Bank project team or as required to reflect the actual Project implementation needs and improvements in institutional capacity.

28. **All direct contracts and the shopping contract for all consultancies with firms estimated to cost US$200,000 equivalent or more will be subject to Bank's prior review by the Bank.** All sole source consultants' contracts and the first contract for each selection method will also be subject to prior review regardless of the amount. Changes in the prior review thresholds can be revised during project mid-term review.

29. **Frequency of Procurement Supervision.** Procurement supervision will be on-going through the review of procurement documents and day-to-day contact with the PIT. Supervision missions, which will include post-reviews and contract administration reviews, will be conducted on a regular basis but at least once a year, depending on the success of the project, number of post-review contracts and other factors. At least 20 percent of the post-review contracts must be reviewed. A country office-based procurement specialist will carry out supervision under the IBRD loan and participate in implementation support missions, site visits, and provide ad hoc advice and support to the procurement staff at PIT, as required.

Environmental and Social (including safeguards)

30. **Project components 1 and 2 do not trigger any World Bank environment or social safeguards policies.** Therefore, the Project has been assigned a Category 'C' in accordance with the World Bank safeguard policy OP/BP/GP 4.01.

Monitoring & Evaluation

31. **Annex 1 lists the main outcome indicators for the project and the principal results, and Annex 2 (Table 9) lists the DLIs.** These will serve as the basis for results monitoring and evaluation. The DIA will be responsible for collecting the data required for monitoring and evaluation and for verification of the DLI's based on clearly defined protocols. Indicators will be measured against agreed targets and compared to defined baselines. Project progress reports will be prepared by the DIA on a quarterly basis and submitted to the Bank review.

32. **For each of the DLIs a comprehensive protocol for verifying the DLIs has been developed and listed in table 10.** These will partially serve as the basis for disbursements in Component 1. Considering the small number of impactful DLIs that assist in achieving the PDO, the World Bank will work closely with the implementing agency (the DIA) to ensure that there are sufficient early warning indicators to ensure compliance with the DLIs. In addition, as part of Component 2, the Board advisor that is chosen will have responsibility for assisting the DIA with ensuring that the DLIs are met and reporting to the World Bank any issues that may arise. Finally, having the DIA serve as the implementing agency will also strengthen the verification process of the DLIs, as the DIA is the responsible entity for meeting most of the DLIs (all of them except for the DLIs related to State-Owned Banks, where the MoF will be responsible for meeting the DLIs).

Role of Partners

33. **The government's financial sector reform program to address the vulnerabilities related to the framework for problematic banks includes the World Bank, the IMF, USAID, and the EC.** Each of the external stakeholders has agreed to a specific technical and financing role related to the three areas above including:

1. *Financing the Deposit Insurance Fund and strengthening the institutional capacity of the Deposit Insurance Agency:* The government has requested a World Bank loan to strengthen the financial and institutional capacity of the Deposit Insurance Agency.
2. *Improving early intervention, particularly for state-owned banks:* The World Bank (through this operation and technical assistance) is supporting the government's efforts to improve its oversight of state-owned banks.
3. *Improving NBS supervision and enforcement:* The IMF conducted a technical assistance mission in early September 2013 to review NBS supervision and enforcement.

In addition, the EC and USAID are providing assistance on drafting any legal changes that are needed to implement the overall reform program.

34. **The government has established a task force to ensure close coordination between the external providers of financial and technical support.** This task force will continue during the implementation of the World Bank project and will be critical to the overall success of the project as the sustainability of the Deposit Insurance System will depend on the overall reform program.

Table 10: Verification Protocols for Disbursement Linked Indicators

DLI	Summary of Verification Protocol
DLI 1: Premiums	DIF bank statement indicating amount of deposit from individual banks per quarter. A statement from the DIA confirming the amount of insured deposits and listing the amount that equals 0.15 percent of insured deposits. Written confirmation from the head of the DIA confirming the amount collected and that it is equal to 0.15 percent of insured deposits based on the previous quarter.
DLI 2: Back-up funding	Submission to the World Bank of the gazette that includes the adopted budget with a line item that identifies back-up funding of at least EUR200 million for 2014 or EUR 50 million for 2015 and the possible uses of the back-up funding that includes financial stability. Confirmation from the Ministry of Finance that this reflects the official budget of the Republic of Serbia for 2014.
DLI 3: Governance	Submission of proof of at appointments to the Board of the DIA based on the appointment published in official gazette and CV of appointee consistent with the agreed to independent criteria. Independence criteria would be defined to (1) exclude individuals who: (i) primarily derive their income directly from the government; (ii) work for the NBS, (iii) work for agencies funded by the Republic of Serbia; (iii) work for public enterprises; (iv) work for a bank that operates in Serbia, or are members of the board of such banks; and (2) not to exclude individuals who carry out academic or research functions (in any capacity) for research institutions or universities owned or funded by the Republic of Serbia. Additionally, the independent board members should have the minimum following qualifications: at least eight years of prior relevant experience in the financial sector, finance, law or auditing within a private company, or academia and research institutes (including those that are publically funded). Written confirmation from the Ministry of Finance and the NBS that both provided approval of each the independent board members appointed. Written confirmation from the Managing Director of the DIA that the Board consists of primarily independent directors and does not include sitting Ministers.
DLI 4: Information Sharing between Financial Safety Net Providers	Written confirmation from the NBS with the dates of the financial stability committee meeting that prove that the meetings were held since January 1, 2014.Written confirmation from the NBS with the information shared with the DIA that includes at least the data outlined, including the dates on which the information was shared.
DLI 5: Recoveries	Written confirmation from the bank that holds the deposit on the amount deposited for individual banks that are in bankruptcy that total from February 1, 2014. Confirmation to include deposit amount from the bank in which the deposits are held and letter from the head of the DIA detailing the assets recovered totaling that amount. Letter from the NBS confirming that the banks in which the recovered amounts are held are designated as systemic banks based on the legal framework of the Republic of Serbia.
DLI 6: Early detection and timely intervention and resolution (of state-owned banks)	Written confirmation from the MoF that audits were completed utilizing TORs that are acceptable to the World Bank by external auditors licensed in Serbia for all banks with at least 20 percent state ownership and that are not in the privatization process that includes the dates on which the audits were completed and the audit firm that conducted the audit. Written confirmation from the MoF of the submission of requisite data for all banks with at least 20 percent state ownership as of the date of submission, and which includes the date that it was received.

ANNEX 4: OPERATIONAL RISK ASSESSMENT FRAMEWORK (ORAF)

REPUBLIC OF SERBIA: Deposit Insurance Strengthening Project

Project Stakeholder Risks						
Stakeholder Risk	**Rating**	**Moderate**				
Risk Description: The banks that operate in Serbia are critical stakeholders, and they could resist the premium increase that is proposed as part of the project.	**Risk Management:** The DIA has already mitigated against this risk by conducting the appropriate outreach with the banks and has presented the overall strategy for strengthening the DIA and financing the DIF					
	Resp: Client	**Status:** Completed	**Stage:** Preparation	**Recurrent:**	**Due Date:**	**Frequency:**
Implementing Agency (IA) Risks (including Fiduciary Risks)						
Capacity	**Rating**	**Low**				
Risk Description: The Deposit Insurance Agency will serve as the Project Implementing Entity. The staff that are needed as part of the Project Implementing Entity worked on another World Bank project and thus have experience with the World Bank's rules and procedure.	**Risk Management:** The project includes DLIs that will improve the ability of the DIA to meet its mandate, and which will also strengthen the DIA's ability to serve as the implementing agency. The World Bank supervision missions will also work closely with the PIT to maintain its capacity to implement the project.					
	Resp: Both	**Status:** Not Yet Due	**Stage:** Implementation	**Recurrent:**	**Due Date:**	**Frequency:**
Governance	**Rating**	**Moderate**				
Risk Description: The governance of the DIA is sufficient to implement the project.	**Risk Management:** The independence of the DIA Managing Board is being strengthened by the project.					
	Resp: Client	**Status:** Not Yet Due	**Stage:** Implementation	**Recurrent:**	**Due Date:**	**Frequency:**
	Risk Management: As an additional safeguard to mitigate project risks, the loan agreement allows for the project to be suspended if the legislation related to the DIA and DIF has been amended, suspended, abrogated, repealed or waived so as to affect materially and adversely the DIA's ability to perform any of its obligations under the project agreement carry out its deposit insurance and bank resolution obligations. The project audit will also verify that any of the World Bank's financing that was utilized was used in line with the legal framework for deposit insurance and bank resolution.					
	Resp: Client	**Status:** Not Yet Due	**Stage:** Implementation	**Recurrent:**	**Due Date:**	**Frequency:**

Project Risks						
Design	**Rating**		**Low**			
Risk Description: The design of the project is a standard Results -Based IPF that has been utilized a number of times successfully.	**Risk Management:** The risks related to not achieving the PDO are mitigated by the results based design of the project.					
	Resp:	**Status:**	**Stage:**	**Recurrent:**	**Due Date:**	**Frequency:**
Social and Environmental	**Rating**		**Low**			
Risk Description: The project is not expected to have any social or environmental impact.	**Risk Management:**					
	Resp:	**Status:**	**Stage:**	**Recurrent:**	**Due Date:**	**Frequency:**
Program and Donor	**Rating**		**Substantial**			
Risk Description: The World Bank lending operation is part of an overall government financial sector reform program and the sustainability of the project partially depends on the successful implementation of the overall reform program.	**Risk Management:** The World Bank is closely working with the government on the overall reform program as well as the other donors that are supporting this effort.					
	Resp: Both	**Status:** In Progress	**Stage:** Both	**Recurrent:**	**Due Date:**	**Frequency:**
Delivery Monitoring and Sustainability	**Rating**		**Low**			
Risk Description: The delivery monitoring is relatively simple as most of the DLIs relate to areas that are under the direct control of the implementing agency for the project. However, as a Results Based IPF, a significant effort will still be needed by the Bank team to monitor the achievement of the DLIs.	**Risk Management:** The World Bank will closely monitor the achievement of the DLIs and as part of the TA component an advisor to the Board will be, amongst other things, responsible for monitoring the DLIs.					
	Resp: Client	**Status:** Not Yet Due	**Stage:** Implementation	**Recurrent:**	**Due Date:**	**Frequency:**

Sector Risk	Rating	Substantial				
Risk Description: There are some vulnerabilities in the Serbian financial system. Non-performing loans (NPLs) in Serbia are among the highest in the region at about 20 percent. Although they appear to be well provisioned, a deterioration in economic conditions could lead to a further decrease in asset quality. In addition, three small banks in which the state had an ownership stake (Agrobanka, RBV, and PBB) failed in 2012 and 2013 due primarily to governance weaknesses that led to a significant deterioration in asset quality. These bank failures have raised concerns about the asset quality in some of the remaining state-owned banks. However, the state-owned banking sector is a relatively minor part of the financial system and outside of two banks that have investments from the IFC and EBRD and are in the privatization process, comprises less than 4 percent of total banking sector assets. Finally, the recent bank failures have resulted in the depletion of the Deposit Insurance Fund (DIF), which poses risks to public confidence in the banking system and stability if there is another bank failure in the future.	**Risk Management:** The one small part of the banking system with possible risk is being targeted by the DLIs related to early detection and timely intervention. In addition, the government is developing its strategy for the state-owned banking sector to minimize any risks going forward. The World Bank is also working closely with the task force that is reviewing the overall legal and regulatory framework for problematic banks. The recommendations from this task force should result in a broader financial sector reform program.					
	Resp: Both	**Status:** In Progress	**Stage:** Both	**Recurrent:**	**Due Date:**	**Frequency:**
Overall Risk						
Overall Implementation Risk:	**Rating**	**Substantial**				

The overall implementation risk is considered substantial. The major risks relate to the current fiscal situation in Serbia and potential vulnerabilities in small pockets of the financial sector. In addition, although there is a comprehensive fiscal reform program that is being planned, there are risks related to this reform program losing momentum due primarily to possible political uncertainty. The World Bank lending operation is also part of an overall government financial sector reform program and the sustainability of the project partially depends on the successful implementation of the overall reform program.

However, the risks related to the design of the project, the delivery monitoring and risks related to the implementing agency are low. The achievement of the PDO is dependent on DLIs being met. Considering that disbursements are contingent on achieving the DLIs (and thus the PDO), the design of the project is considered to be low risk. In addition, the technical assistance being provided in Component 2 further decreases the risk that the DLIs (and thus the PDO) are not met. The delivery monitoring risk is also low as there are a small number of DLIs that will need to be monitored and the monitoring is being done by the same agency that is responsible for achievement of the majority of the DLIs. The DIA, as the project implementing entity, also has experience with World Bank lending operations that span almost a decade and has the capacity and the experience to implement the project.

As an additional safeguard to mitigate project risks, the loan agreement allows for the project to be suspended if the legislation related to the DIA and DIF has been amended, suspended, abrogated, repealed or waived so as to affect materially and adversely the DIA's ability to perform any of its obligations under the project agreement and carry out its deposit insurance and bank resolution obligations. In addition, the audit will be extended to include verification of the DLIs and also will ensure that any of the World Bank financing in the DIF that is utilized is independently audited to ensure that it was used only for deposit insurance and bank resolution functions.

ANNEX 5: IMPLEMENTATION SUPPORT PLAN

REPUBLIC OF SERBIA: Deposit Insurance Strengthening Project

A. Strategy and Approach for Implementation Support

1. **The Bank's Implementation Support (IS) strategy lays out the activities that the Bank team will implement, as well as the project design and monitoring features that it will adopt, in order to mitigate the most significant risks identified in the ORAF.** These risks relate to: (i) the sector risk, in particular related to state-owned banks; and (ii) and the program risk related to the World Bank lending operation being part of an overall government financial sector reform program and the sustainability of the project partially depending on the successful implementation of the overall reform program. The IS strategy relies on project design features and technical assistance as enabling tools for risk mitigation. The IS for mitigating the two key risks is addressed below.

- *The sector risk, in particular related to state-owned banks.* Even though overall banking system is stable, there are uncertainties related to the state-owned banks. These weaknesses are addressed through a DLI that improves the monitoring of state-owned banks. The DLI related to targeting improvements in overall information sharing will also contribute to proper early identification of problems in the overall banking sector. In addition to this, the project includes a significant TA component that supports the achievement of these two DLIs.
- *The program risks related to the linkages of the World Bank operation with the overall government financial sector reform program.* The World Bank lending operation is part of an overall government financial sector reform program and the sustainability of the project partially depends on the successful implementation of the overall reform program. In order to mitigate this risk, the implementation support strategy will focus on working closely with the government on the overall reform program as well as the other donors that are supporting this effort.

B. Implementation Support Plan

2. **During project implementation, the Bank's financial management supervision of Component 1 will be conducted through** (i) verification of financing of the DIF after each advance, and (ii) review of annual audits of the designated account. Any changes in the control and operating environment within the NBS will be monitored and the NBS audit reports will be reviewed.

3. **For the project's Component 2, the supervision will take a traditional approach and will be conducted in two main ways:** (i) review the project's interim un-audited financial reports for each calendar semester, the audited project financial statements and auditor's management letter, as well as the DIA's entity financial statements audit; (ii) perform on-site supervision with the frequency based on the assessed project's risk and performance (first supervision in 12 months' time after the assessment); and (iii) review the project's financial management and disbursement arrangements to ensure compliance with the World Bank's

minimum requirements. The on-site supervision will include the review of the following areas of the project's financial management: accounting and reporting, internal control procedures and external audits, planning and budgeting, funds flow and staffing arrangements. The review will include all types of payments, namely operating cost, acquisition of goods and services. A sample transactions review will also be conducted. Implementation support and supervision will be performed by the Bank accredited Financial Management Specialist.

4. **The Bank will support project implementation using its own staff as well as international consultants.** The Bank team supporting the project will be sourced from Bank offices in Washington DC, Serbia and other countries in ECA. In addition, the Bank team will provide support to the DIA as required. The number of staff weeks envisioned for the first year is 38, with an additional 36 for the following year.

Task Team Skills Mix Requirements for Implementation Support

Time	Focus	Skills Needed	Resource
First 12 months	Team Leadership	Project management	10 staff weeks (SW)
	Financial Management (FM) training	FM Specialist	2 SW
	Day to day coordination	Operations Officer	14 SW
	Operational Support	Program Assistant	4 SW
	Procurement Support	Procurement Specialist	2 SW
	International consultant	Deposit Insurance Expert	4 SW
12 - 24 months	Team Leadership	Project management	10 SW
	Financial Management (FM) training	FM Specialist	2 SW
	Day to day coordination	Operations Officer	12 SW
	Operational Support	Program Assistant	4 SW
	Procurement Support	Procurement Specialist	4 SW
	International consultant	Deposit Insurance Expert	4 SW