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Draft of Analysis of the existing impediments to the sale of NPLs in Serbia

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Glossary

AMC	Asset Management Company	RCC	Resolution and Collection Corporation
AQR	Asset Quality Review	SoW	Scope of Work
ABS	Asset-backed security	SPA	Share Purchase Agreement
CCB	China Construction Bank	SME	Small and Medium-sized Enterprises
CRE	Commercial Real Estate	SOCB	Southcoast Financial Corporation
CPs	Condition Precedents	SPV	Special Purpose Vehicle
CDRAC	Corporate Debt Restructuring Advisory Committee	SOE	State Owned Entities
CIT	Corporate Income Tax	CHF	Swiss Franc
EUR	Euro	UPPR	Pre-packaged reorganization plan as defined by the Serbian Law on Bankruptcy, Also covers reorganisation plans adopted within the insolvency procedure.
EBRD	European Bank for Reconstruction and Development	VAT	Value-Added Tax
ECB	European Central Bank		
FRA	Financial Sector Restructuring Authority		
FX	Foreign Exchange		
GoS	Government of Serbia		
HUF	Hungarian Forint		
MNB	Hungarian National Bank		
IAS	International Accounting Standards		
IFC	International Finance Corporation		
IFRS	International Financial Reporting Standards		
IMF	International Monetary Fund		
KYC/AML	Known your customer/Anti-Money Laundering		
LIP	Loss identification period		
LTV	Loan to value		
LGD	Loss given default		
M&A	Mergers and Acquisitions		
MoF	Ministry of Finance		
MoJ	Ministry of Justice		
NBS	National Bank of Serbia		
NDA	Non-disclosure agreement		
NPE	Non-performing entity		
NPL	Non-performing loan as defined by the National Bank of Serbia		
OCI	Other Comprehensive Income		
PIT	Personal Income Tax		
PD	Probability of Default		
P&L	Profit and Loss		
RRE	Residential Real Estate		

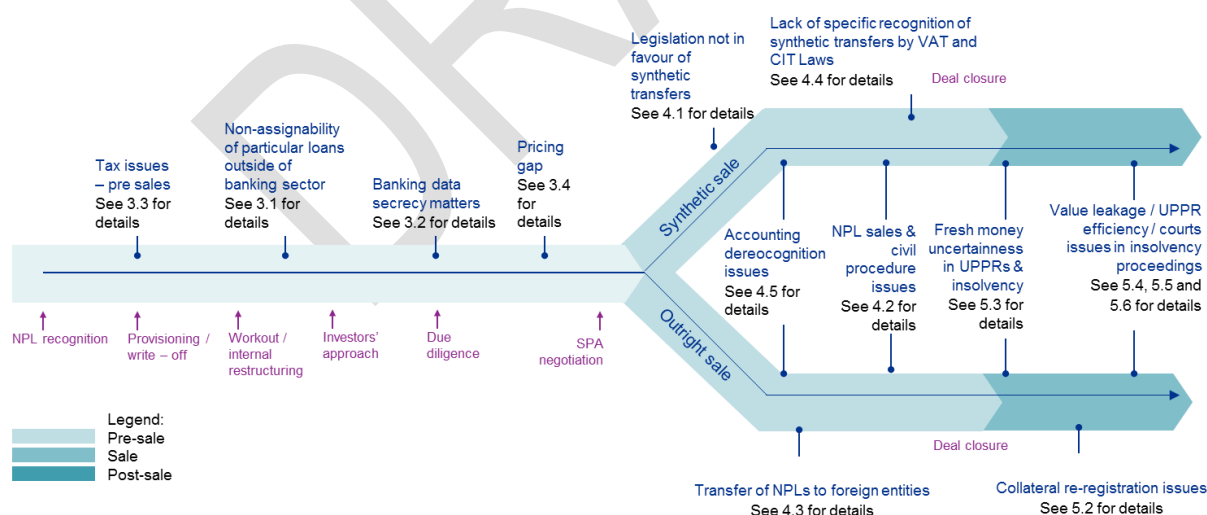
1.1 Foreword and Context

Non-performing loans have been recognized as an obstacle to further economic prosperity in Serbia and the Government set up a working group to address the NPL issue. As part of this initiative, this study was mandated by EBRD to identify existing impediments for the sale of NPLs from a financial, accounting, legal, and tax point of view, and to propose changes to existing legislation (where deemed necessary).

Our findings and recommendations are primarily focused on amending existing laws and bylaws. There are however practical aspects leading to impediments to the NPL market development. The biggest practical bottleneck for the overall improvement of investment climate in Serbia remains the ineffective court practice and enforcement of laws, ineffective functioning of land cadastres, unreliable management of the estate by administrators i.e. bankruptcy managers, and generally speaking a still inappropriately high level of bureaucracy.

A study of this kind requires a good understanding of the standard transactions that may take place and the different stages. In our view, there are two main types of transactions.

- A full transfer of NPL from a bank to an investor (“outright sale”);
- Synthetic transfers involve all situations where the original lender remains nominal lender of record and contractual party with the borrower, while the "buyer" (i.e. the sub-participant) agrees solely with the original lender to assume economic risks and benefits associated with the underlying loan (“synthetic sale”).



1.2 Key recommendations

A summary of the most important issues and recommendations identified as part of the Study is presented below, while low priority issues and recommendation are discussed further in the text.

Reference numbers correspond to chapters in the body of the Study.

List of identified impediments:

Executive summary reference	Key impediments
3.1 Existing regulatory framework governing transferability of NPLs	i. Certain obligations of both banks and their borrowers not automatically transferred with the assigned claim
	ii. Inability of charging of "interest on due interest" by non-banking buyer
	iii. Non-assignability of retail NPLs outside of banking sector
	iv. Non-assignability of performing (corporate) loans outside banking sector
3.2 Banking data secrecy matters	i. Broad definition of banking secrecy with limited exceptions
	ii. Inability of banks to process/transfer personal data of defaulting clients to third parties
3.3 Pre sales taxation matters	i. Ambiguously interpreted rules for tax deductibility of bad debt provisions / write-off
	ii. Strict requirements for write-off of receivables
	iii. Misinterpretation that write off equals debt release
	iv. Treatment of receivable write-off for individuals as their private income
3.4 Commercial aspect - pricing gap	i. Varying interpretations of loan loss provisioning in accordance with IFRS
	ii. Inadequate collateral valuations
	iii. Lack of adequate historical data in small and medium banks
	iv. Insufficient historical data on collateral realization
4.1 Synthetic NPL sale vs. outright sale	i. The current legislation does not explicitly recognize synthetic sale arrangements
	ii. Not recognizing sub-participant as creditor under the insolvency
4.2 NPL sales and Civil procedure	i. Inability of NPL acquirer to take over an ongoing dispute
4.3 Transfer of NPLs to foreign entities	i. Prohibition of loan transfers to foreign entities
	ii. Necessity of formal registration of loans & changes
	iii. Necessity of borrowers' consent to a change of lender in particular cases
	iv. Restricting entities in Serbia to provide cross border guarantees only to their foreign subsidiaries.
4.4 Tax related aspects of a NPL transaction	i. Lack of specific recognition of synthetic transfers by VAT and CIT Laws
4.5 Accounting aspects	i. Strict derecognition criteria as prescribed by the IFRS
5.1 Transfer of collateral	i. Inefficiency of mortgage re-registration
	ii. Insufficient capacity of the second instance authorities
	iii. Influence of pledge/mortgage change on the rank/priority
5.2 Fresh money injection	i. Lack of guarantees for super-seniority of new money under UPPRs / judicial insolvency reorganization
	ii. New money under UPPR not qualifying as a liability in the insolvency
5.3 Related party issues linked with NPLs under restructuring / insolvency	i. Systematic use of related party transactions and the deterioration of value for the creditors in large complex NPL cases
5.4 Group restructurings	i. Regulating UPPR of a debtor as an individual company and not as a part of the corporate group by the Insolvency Act
5.5 Adoption of a reorganization plan	i. Possibility of one class of dissenting creditors (irrespective of its size) to prevent adoption of the reorganization plan / UPPR
	ii. Lack of technical and human capacity and experience of courts dealing with insolvency/UPPR cases
	iii. Practical issues with debt to equity swaps

Overview of key Impediments and Recommendations

Key Impediments	Recommendations	Expected benefits	Relevant Authority
3.1 Existing regulatory framework governing transferability of NPLs			
<ul style="list-style-type: none"> ■ The obligations of both banks and their borrowers mostly administrative, (e.g. interest calculations, information regarding indebtedness, etc.) are not automatically transferred with the assigned claim 	<ul style="list-style-type: none"> ■ Amendment of the Obligations Act and/or the Banking Act by which obligations inherently tied and directly related to the assigned bank NPL should be automatically transferred together with NPL receivables 	<ul style="list-style-type: none"> ■ Simplifying regulatory burdens and improving conditions for development of the NPL market 	<ul style="list-style-type: none"> ■ Ministry of Justice ■ National Bank of Serbia
<ul style="list-style-type: none"> ■ Non-banking institutions may not benefit from the statutory exemption on calculation of interest on due interest („kamata na kamatu“) 	<ul style="list-style-type: none"> ■ Amendment of the Obligations Act to explicitly include those who have been assigned NPLs i.e. legal successors of banks to benefit from the statutory exemption 	<ul style="list-style-type: none"> ■ Increasing attractiveness of the NPL market by allowing debt investors to charge additional interest ■ Create an even playing field between investors (banks and non-banks) 	<ul style="list-style-type: none"> ■ Ministry of Justice

Key Impediments	Recommendations	Expected benefits	Relevant Authority
<ul style="list-style-type: none"> ■ Non-assignability of NPLs related to natural persons (Retail Loans) to a legal entity other than a Serbian fully licensed bank; this limits the creation and development of a secondary retail debt market 	<ul style="list-style-type: none"> ■ Reconsider licencing requirements for all NPLs to other regulated or unregulated entities (e.g. lighter touch regulation, full liberalization) ■ We acknowledge concerns about the potential misconduct around customer protection topic; such issues can be regulated in our view in several different ways, as suggested in our report (e.g. single customer protection authority, licensing of debt investors) 	<ul style="list-style-type: none"> ■ Attract foreign investors specialized in retail NPLs (some of them already present on the market) ■ Freeing up banks and possibly courts from legal proceedings against borrowers natural persons (debt investors having usually a different collection approach to banks, usually going for out-of-court solutions) ■ Increasing local NPL servicing capacity 	<ul style="list-style-type: none"> ■ National Bank of Serbia ■ Consumer Protection Authorities
<ul style="list-style-type: none"> ■ Non-assignability of performing (corporate) loans outside banking sector may prevent effective resolution of large distressed borrower groups under 	<ul style="list-style-type: none"> ■ Enabling assignment of corporate performing loans outside the banking sector in specific cases of distressed borrowers which belong to a group of borrowers having also 	<ul style="list-style-type: none"> ■ Enabling easier resolution of large complex NPLs and thus attracting investors interested in such individual cases 	<ul style="list-style-type: none"> ■ National Bank of Serbia

Key Impediments	Recommendations	Expected benefits	Relevant Authority
restructuring	non-performing and performing loans (borrower unit principle)		
3.2 Banking and data secrecy matters			
<ul style="list-style-type: none"> ■ The definition of banking secrecy is rather broad with limited exceptions which do not exempt NPL transactions, with the consequence that potential investors will not be able to perform a comprehensive and complete due diligence of a target loan portfolio or of a whole bank ■ Banks may not process (nor transfer) personal data of defaulting clients to any third party without consent of the client 	<ul style="list-style-type: none"> ■ Amendment of the Banking Act to provide for a possible exemption for NPLs from banking secrecy restrictions i.e. providing that information related to NPL portfolio and the underlying debtors are not subject to banking secrecy and may be disclosed to interested third parties (e.g. Romania did not have such exemption and court practice had to step in to ensure that bank secrecy does not impede NPLs transferability; in order to avoid similar litigations in Serbia, banking secrecy exemption for NPLs should be regulated directly in the Banking 	<ul style="list-style-type: none"> ■ Allowing investors to perform comprehensive and complete due diligence thus increasing attractiveness of the NPL market ■ Gap in pricing expectations between seller and buyer may be reduced if buyer is better informed about subject of the deal 	<ul style="list-style-type: none"> ■ Ministry of Finance on the initiative of private sector (e.g. Association of banks) ■ Commissioner for Information Public Importance and Personal Data Protection

Key Impediments	Recommendations	Expected benefits	Relevant Authority
	<p>Act); if safeguarding confidential information is of concern, a standard procedure with the NBS may be introduced, i.e. the standard NDA approved by the NBS</p> <ul style="list-style-type: none"> ■ Further amendment of the Banking Act to allow processing and transferring personal data between banks and investors for NPL transactions ■ The Data Protection Act should be amended so that no new consent is required if the purpose for processing personal data does not significantly deviate from the banks' purpose; if safeguarding confidential information is of concern, a standard procedure with the Commissioner for Information of Public Importance and Personal Data Protection may be introduced, i.e. 		

Key Impediments	Recommendations	Expected benefits	Relevant Authority
	<p>standard NDA approved by the Commissioner</p>		
<p>3.3 Pre sales taxation matters</p>			
<ul style="list-style-type: none"> ■ Rules for tax deductibility of bad debt provisions / write-off for banks are often ambiguously interpreted in practice ■ Strict requirements for write-off of receivables have caused banks to choose impairment approach over direct write-offs, thus affecting their willingness to dispose such loans ■ Overall misinterpretation in practice that write-off is equal to debt release 	<ul style="list-style-type: none"> ■ The CIT Law should be amended in a manner not to create disincentives for banks to deduct expenses in relation to write-off of receivables. ■ The Laws (both CIT and PIT) should clearly state that an accounting write-off does not represent a legal debt release. The recently introduced law amendments did not resolve this issue in our view. 	<ul style="list-style-type: none"> ■ Encourage banks to write-off NPLs and accordingly increase their willingness to sell NPLs ■ Possibly reduce gap in pricing expectations between sellers and buyers 	<ul style="list-style-type: none"> ■ Ministry of Finance ■ Tax Authority

Key Impediments	Recommendations	Expected benefits	Relevant Authority
<ul style="list-style-type: none"> ■ Write-off of receivables from natural persons is considered as taxable other income of individuals, according to the Personal Income Tax Law and available practice, if the bank did not fulfill prescribed CIT conditions for tax deduction of write-off expenses 	<ul style="list-style-type: none"> ■ Amendment of the PIT Law to clearly stipulate that accounting write-off is not a taxable event. The recently introduced law amendments did not resolve this issue in our view. 	<ul style="list-style-type: none"> ■ Encourage banks to write off retail NPLs and accordingly increase their willingness to faster resolve / sell retail NPLs 	<ul style="list-style-type: none"> ■ Ministry of Finance ■ Tax Authority
3.4 Commercial aspect – pricing gap			
<ul style="list-style-type: none"> ■ Varying interpretations of loan loss provisioning in accordance with IFRS means that the levels of provisioning are based on often over-inflated collateral ■ Valuations are very often inadequate due to inactive real 	<ul style="list-style-type: none"> ■ Improving impairment provisioning practice in line with IAS 39 should be a key priority given reliance on collateral values ■ There is a necessity for comprehensive framework and regulation in the field of collateral 	<ul style="list-style-type: none"> ■ Potentially reducing gap in pricing expectations between buyers and sellers and boosting NPL market 	<ul style="list-style-type: none"> ■ National Bank of Serbia ■ Ministry of Finance

Key Impediments	Recommendations	Expected benefits	Relevant Authority
<p>estate market, insufficient appraisers' know-how and the applied models are not in line with the best international valuation practices</p> <ul style="list-style-type: none"> ■ Small and medium-sized banks do not possess adequate historical data required as a basis for assessing and calculating inputs for collective provisioning models, i.e. PDs, LGDs, LIP ■ For the individual assessment for provisioning in accordance with IAS 39, many banks very often do not possess sufficient information on historical collateral realization to substantiate the discounts applied to collateral as well as the realization periods 	<p>appraisers; it is our understanding that the Ministry of Finance is working on a new framework aiming at stricter rules for appraisers licensing as well as improvement of overall valuation practice</p> <p>Issuance of a Provisioning Guidance is of necessity, especially for small and medium-sized banks, in cases where historical data is insufficient to support parameters used for collective basis provisioning, but also for the individual assessment, as these banks usually do not possess adequate internal statistical data; this guidance would suggest acceptable approach when it comes to calculation of e.g. PDs, LGDs, etc. for collective provisioning purposes, but also approach when it comes to discounts for collateral and periods of realization; we understand that the NBS is currently working on such</p>		

Key Impediments	Recommendations	Expected benefits	Relevant Authority
	<p>guidelines.</p> <p>Preparation of a Debt Investor Guide in Serbia, which would assist new investors to get acquainted with the most relevant legislation regarding NPL deals / business, including practical issues and obstacles as stated in this Study</p>		
4.1 Synthetic NPL sale vs. outright sale			
<ul style="list-style-type: none"> ■ The current legislation does not explicitly recognize synthetic sale arrangements ■ A sub-participant is not recognized as a creditor with a separation right (i.e. a secured creditor) under current creditor's insolvency (in the potential 	<ul style="list-style-type: none"> ■ Relevant authorities should possibly recognize synthetic sale arrangements as a concept in order to avoid any misunderstandings whether such concept is feasible under our legislation ■ Amendment of the Insolvency Act to grant a sub-participant under a synthetic NPL transfers the status of 	<ul style="list-style-type: none"> ■ Increasing space and flexibility for different forms of NPL transactions by recognizing and allowing synthetic sales transactions ■ Increased level of NPL transactions 	<ul style="list-style-type: none"> ■ National Bank of Serbia ■ Ministry of Justice ■ Ministry of Economy

Key Impediments	Recommendations	Expected benefits	Relevant Authority
synthetic sale arrangement)	<p>a creditor with a separation right; this treatment already exists in the Serbian legal system in cases of insolvency of custody banks</p>		
4.2 NPL sales and Civil procedure			
<ul style="list-style-type: none"> ■ An NPL acquirer does not have the right to take over an ongoing dispute, either as defendant or plaintiff, unless this is expressly consented to by the plaintiff or defendant ■ There is a risk that an ongoing dispute can affect the desired regulatory capital relief and de-recognition of the loan from the books of the original creditor (bank) 	<ul style="list-style-type: none"> ■ Amendment of the Civil Procedure Act to grant unconditional right to the new creditor (NPL acquirer) to step into all rights of the previous creditor by issuing a simple note to the court, without additional consent from the counterparty 	<ul style="list-style-type: none"> ■ Simplifying management of NPLs and improving conditions for development of the NPL market 	<ul style="list-style-type: none"> ■ Ministry of Justice

Key Impediments	Recommendations	Expected benefits	Relevant Authority
4.3 Transfer of NPLs to foreign entities			
<ul style="list-style-type: none"> ■ A loan entered into between a Serbian bank and a Serbian resident entity may not be transferred to a foreign entity. ■ Foreign investors are restricted in advancing loans to Serbian residents given that, under the F/X Act and NBS's regulations, all such cross-border loans (and their further amendments) have to be registered with the NBS immediately upon their signing without this registration, a cross-border loans are practically inoperable since no funds may be wired in or out of Serbia based on them ■ A resident borrower can in 	<ul style="list-style-type: none"> ■ The F/X Act should explicitly allow the sale of local NPLs to foreign entities ■ Specific Serbian regulatory inventory for cross-border transactions laid down in the F/X Act and by-laws should be reformed so that registration of a loan or any change thereto is not a condition for its validity and operability; instead of rubber-stamping each cross-border transaction (and changes), a notification to the NBS on cross-border transactions should suffice ■ The F/X Act and by-laws should not impose a requirement that a resident borrower acknowledges and 	<ul style="list-style-type: none"> ■ Allowing foreign investors to purchase NPLs directly, without registering as local companies and thus increasing attractiveness of the market 	<ul style="list-style-type: none"> ■ National Bank of Serbia ■ Ministry of Finance

Key Impediments	Recommendations	Expected benefits	Relevant Authority
<p>practice frustrate a change of lender since its cooperation is needed (i) when making a three-party agreement or issuing a required statement and (ii) when executing the NBS forms for registering a new lender of record.</p> <ul style="list-style-type: none"> ■ A legal entity resident in Serbia may provide cross-border security interests over its assets and/or corporate guarantees securing obligations only of non-resident debtors which are majority owned by such Serbian resident security provider / guarantor 	<p>executes NPLs sale</p> <ul style="list-style-type: none"> ■ Residents should be able to grant security for the benefit of foreign entities without requirement that foreign debtors are majority owned subsidiaries of Serbian residents. 		
<p>4.4 Tax related aspects of a NPL sales transaction</p>			
<ul style="list-style-type: none"> ■ Synthetic sale of NPLs not specifically recognized by VAT and 	<ul style="list-style-type: none"> ■ The Law on VAT or relevant bylaws should be modified to clarify that VAT 	<ul style="list-style-type: none"> ■ Allowing flexible forms of NPL transfer and reducing the risk of 	<ul style="list-style-type: none"> ■ Ministry of Finance

Key Impediments	Recommendations	Expected benefits	Relevant Authority
<p>CIT Laws thus may cause misinterpretation in practice leading to the application of different tax rules from those that would apply to outright sale</p>	<p>exemption is applicable to both synthetic and outright sale of receivables; synthetic transfer of receivables where the bank transfers the rights over the NPL portfolio, should also be VAT exempt</p> <ul style="list-style-type: none"> ■ From a CIT perspective it would be appropriate to clarify in CIT Law or the Rulebook on Tax balance sheet that the transfer of substantially all rewards and risks in relation to NPL should be treated as a sale of receivables. ■ VAT Rulebook should also provide that collection activities performed by the buyer of receivables who acquired substantially all risks and rewards on receivables via synthetic transfer should not be treated as free of charge services provided to transferor, notwithstanding the fact 	<p>tax challenges thus increasing attractiveness of the NPL market for investors</p>	<ul style="list-style-type: none"> ■ Tax Authority

Key Impediments	Recommendations	Expected benefits	Relevant Authority
	that the transferor has retained legal rights		
4.5 Accounting aspects			
<ul style="list-style-type: none"> ■ The analysis for accounting derecognition of financial assets at sales under IFRS by sellers i.e. banks, often misinterpreted in practice by sellers and buyers ■ The legal form (contracts), NBS notification and closing of transactions are not sufficient evidence of accounting derecognition as per the IFRS 	<ul style="list-style-type: none"> ■ Consistent application of the derecognition concept and fulfillment of the derecognition criteria as defined in IAS 39; should be considered to be stipulated in certain form by the regulator ■ All transactions should be analyzed on a case by case basis to check the derecognition criteria; most important is transfer of risks and rewards; In practice, derecognition takes place when criteria according to IFRS are met, i.e. transfer of risks and rewards through signing of an SPA 	<ul style="list-style-type: none"> ■ Avoiding practical issues when it comes to analysis on effects on banks' balance sheets, thus possibly increasing willingness of the banks to sell NPLs 	<ul style="list-style-type: none"> ■ National Bank of Serbia

Key Impediments	Recommendations	Expected benefits	Relevant Authority
	<ul style="list-style-type: none"> Legal obligations, such as notification to the NBS, SPA signing etc., should not determine the timing of derecognition but rather transfer of substantially all risk and rewards linked with NPLs from seller to buyer, in line with IFRS criteria 		
5.1 Transfer of collateral			
<ul style="list-style-type: none"> Re-registration of mortgagees in the name of the new creditor (acquirer of NPL) is extremely slow due to the inefficiency of the real estate cadasters The underlying debtor (borrower) may frustrate the re-registration process by lodging an appeal (even frivolous) before a second 	<ul style="list-style-type: none"> In order to avoid that an appeal from the underlying debtor significantly delays the perfection of the security for the acquirer, the appeal by itself should not suspend the re-registration and perfection of the security interest for the benefit of the acquirer The Secured Transactions Act and 	<ul style="list-style-type: none"> Improved certainty for the acquirer of NPL on the enforceability of the collateral attached to the NPL 	<ul style="list-style-type: none"> Ministry of Justice Ministry of Construction, Transport and Infrastructure

Key Impediments	Recommendations	Expected benefits	Relevant Authority
<p>instance court against such re-registration. Due to understaffing of the second instance authorities, completion of re-registration might take several years; this severely affects investors' assessment of the NPL portfolio (incl. price)</p> <ul style="list-style-type: none"> ■ Any amendments to the security agreement which would alter essential elements ('bitne elemente') of the pledge / mortgage would affect priority/ranking of such pledge / mortgage i.e. it would be considered as a new pledge / mortgage and therefore would have the priority as of the day of inscription of such alteration in the Pledge Registry / the Real Estate Cadaster (and thus different 	<p>the Mortgage Act should explicitly provide that a change of the secured creditor in the pledge registry / the real estate cadasters shall not cause a loss of the initially established priority of the respective security interest</p>		

Key Impediments	Recommendations	Expected benefits	Relevant Authority
<p>hardening period), ranking lower than pledges / mortgages registered before the alteration. There is no consistency in the practice as to which elements of the pledge / mortgage should be considered as essential elements.</p>			
<p>5.2 Fresh money injection</p>			
<ul style="list-style-type: none"> ■ There are practical issues in implementing UPPRs and restructurings in general, important shortcoming is the lack of new funding to achieve going concern of the business in difficulty and to support restructuring measures ■ Providers of fresh funds are currently protected only in case of 	<ul style="list-style-type: none"> ■ Enabling the possibility for new money priority under the UPPR / court restructurings and incentivizing investors to provide new money with super-seniority over existing creditors ■ Amendment of the Insolvency Law to clearly mention the possibility that the provider of new money will be granted super-seniority under 	<ul style="list-style-type: none"> ■ Ensure survival of NP debtors by injection of new money thus stimulating debt investors to purchase complex NPL cases under restructuring / insolvency 	<ul style="list-style-type: none"> ■ Ministry of Justice ■ Ministry of Economy

Key Impediments	Recommendations	Expected benefits	Relevant Authority
<p>insolvency. Namely, loans taken by the insolvency administrator upon opening of insolvency are treated as liabilities of the insolvency estate (<i>obaveza stečajne mase</i>) and enjoy priority in the distribution of insolvency proceeds, ranking ahead of employment and tax liabilities and other insolvency creditors (new money priority). Such new money priority/super-seniority is not guaranteed in the UPPR / judicial insolvency reorganization procedure; it requires the voting by simple majority of each class of creditors</p> <ul style="list-style-type: none"> ■ Lending new money via related parties may fall under the rules of equitable subordination i.e. related party creditor (non-bank) may be subordinated into fourth (final) 	<p>certain conditions, e.g. voting of certain percent of existing creditors or of overall exposure (avoid separate class voting)</p> <ul style="list-style-type: none"> ■ It should be also specifically clarified in the Insolvency Act that, in case of failure of the UPPR / court restructurings, this super-seniority should be retained by way of qualifying it as liability of the insolvency estate 		

Key Impediments	Recommendations	Expected benefits	Relevant Authority
<p>payment priority rank in insolvency proceedings</p>			
<p>5.3 Related party issues linked with NPLs under restructuring / insolvency</p>			
<ul style="list-style-type: none"> ■ Systematic use of related party transactions and the deterioration of value for the creditors in large complex NPL cases, deterring investors to invest in such NPLs; we believe this issue is aggravated by the existence of the centralized blocked account mechanism (“blokada računa“) which encourages debtors to re-direct cashflows and is open to abuse by related parties. 	<ul style="list-style-type: none"> ■ Consider abolishing / amending the centralized blocked account mechanism; such mechanism is not widely recognized in comparative practice, its overall effects seem to be rather negative ■ Existing criminal acts with regards to related party schemes and value leakage to be strictly enforced 	<ul style="list-style-type: none"> ■ Prevention of value leakage in large group NPL cases thus stimulating debt investors to purchase complex NPL cases in restructuring / insolvency 	<ul style="list-style-type: none"> ■ Ministry of Justice ■ Ministry of Economy ■ National Bank of Serbia
<p>5.4 Group restructurings</p>			

Key Impediments	Recommendations	Expected benefits	Relevant Authority
<ul style="list-style-type: none"> ■ The Insolvency Act regulates the judicial insolvency reorganization / UPPR of a debtor as an individual company and not as a part of the corporate group, causing many practical issues when it comes to solutions regarding large complex NPLs. Therefore, for the reorganization / UPPR of each member of the corporate group, a separate case file is assigned, and if respective group members are seated in different places, separate local courts will be competent and separate insolvency judges will be appointed 	<ul style="list-style-type: none"> ■ It should be considered that the Serbian Insolvency Act is amended in order to explicitly regulate and permit the joint reorganization / UPPR which will enable that reorganization of an entire corporate group is carried out within single procedure and within the same court and before one insolvency judge. This joint UPPR does not disregard separate legal personalities of each group member companies because creditors of each company would have separate voting rights 	<ul style="list-style-type: none"> ■ Enabling efficient restructuring plan adoption for large group NPLs thus stimulating debt investors to purchase complex NPL cases under restructuring / insolvency 	<ul style="list-style-type: none"> ■ Ministry of Justice ■ Ministry of Economy
5.5 Adoption of a reorganization plan			
<ul style="list-style-type: none"> ■ A reorganization plan / UPPR is 	<ul style="list-style-type: none"> ■ Further amendments to the Serbian 	<ul style="list-style-type: none"> ■ Enabling efficient restructuring 	<ul style="list-style-type: none"> ■ Ministry of Justice

Key Impediments	Recommendations	Expected benefits	Relevant Authority
<p>only approved if each creditors class votes in favor of its adoption; a creditor class approves the plan by a favorable vote of its members who hold more than 50% (simple majority) of the amount of claims in that class; This means that only one class of dissenting creditors (irrespective of its size) can prevent adoption of the reorganization plan / UPPR, even if all other classes and creditors have supported the reorganization plan / UPPR</p> <ul style="list-style-type: none"> ■ Practical issues of implementing Insolvency Law caused by lack of technical and human capacity and experience of courts dealing with insolvency/UPPR cases ■ Practical issues with debt / equity swaps in NPLs under 	<p>Insolvency Act should be considered, subject to satisfactory checks and balances, to ensure that a reorganization plan / UPPR may be adopted even if one or more classes are against it (so called ‘cram-down mechanism’), for example: 1) creditors holding certain 2/3 of the total amount of claims have voted in favor of the reorganization plan / UPPR, irrespective of their division within separate classes; and 2) dissenting class of creditors may not be unfairly impaired</p> <ul style="list-style-type: none"> ■ Further, for the purpose of more efficient implementation of insolvency rules, it should be considered whether special departments within commercial courts are designated specifically for insolvency/UPPR cases 	<p>plan adoption for large group NPLs thus stimulating debt investors to purchase complex NPL cases under restructuring / insolvency</p>	<ul style="list-style-type: none"> ■ Ministry of Economy

Key Impediments	Recommendations	Expected benefits	Relevant Authority
<p>restructuring seen in practice (e.g. opposition by existing shareholders), preventing effective restructurings and distracting investors to invest in large complex NPLs</p>	<ul style="list-style-type: none"> ■ It should be considered that the Serbian Insolvency Act is amended in order to make clear that if a debt to equity swap is approved by creditors as a measure of the UPPR, the existing shareholders do not have the right to ask to additionally approve such debt to equity swap. 		

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2 Introduction

2.1 Purpose of the Study

High and still rising level of NPLs in Serbia has become a source of systematic risk in the economy. The Government of Serbia (GoS) has recognized the necessity of cleaning the banking sector balance sheet in order to stimulate new lending activity as well as support the economy in achieving sustainable growth rates.

Therefore, the Government has adopted an NPL resolution strategy, which aims to provide incentives and eliminate barriers identified in the system preventing timely resolution of NPLs and to establish a system which will prevent the accumulation of non-performing loans to the level which might have a material adverse effect on credit activity and economic growth. The focus of the strategy and solutions are market oriented.

One of the key areas and objectives identified by the strategy is to assess all obstacles to the sale of NPLs. As part of the initiative, EBRD has provided technical support and engaged KPMG in Serbia, together with the law firm Moravčević, Vojinović and partners in cooperation with Schoenherr, to analyse impediments to sale of NPLs in Serbia, from regulatory, tax, accounting, and commercial i.e. practical point of view and to provide recommendations that would ideally lead to the removal of key barriers identified.

As part of our work we have conducted the following activities:

- organized several meetings with some of the key stakeholders: National Bank of Serbia, Ministry of Finance, Ministry of Justice;
- reviewed relevant laws and bylaws relevant for the subject matter, but also focusing on the points defined in our Scope of Work as per the suggestions of EBRD and the Working Group;
- analysed certain solutions adopted in other countries which we found applicable, and discussed key topics from this study with our colleagues from our international network in order to understand applicability of their solutions (mainly Romania, Bulgaria, ex Yugoslavian countries, Austria, other CEE countries);
- reviewed existing studies and materials with similar subject from other countries;
- used our practical experience from relevant projects with local banks and investors interested for Serbia, including NPL deals on which we have assisted either to buyers or sellers.

2.2 Content and structure of the Study

The Study follows the chronological order of a typical NPL sales deal. The Study therefore analyzes obstacles which either sellers or buyers face or might face during **pre-sales, sales** and **post-sales stage**, and which avert sellers and/or buyers to enter into transaction of sale and purchase of NPL. The obstacles we have analyzed include tax related matters, legal and regulatory environment, accounting matters, commercial matters and any other practical impediments.

Key focus areas of the Study were as follows:

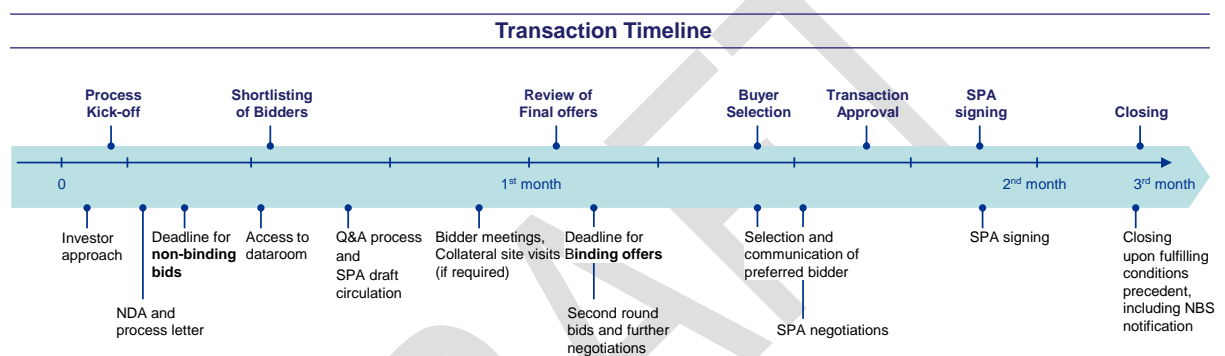
- Analysis of existing regulatory obstacles to the sale of NPLs, noting the differential treatment of different types of loans (e.g. retail, corporate);
- Potential differences between loans in foreign and local currency;
- Contract law, including the Code of Obligations and consumer protection laws that may bear on the relationship between the seller and the buyer of a loan;
- The legal structures currently available for the sale (broadly defined) of NPLs, and what structures ought to be available in light of international best practice - assignment, transfer etc.;
- Security rights over the property: issues related to the transfer of mortgages, share pledges and property ownership in connection with the sale of NPLs, including questions connected with public registries (e.g. land registry, pledge registry, central depository share-pledge registry);
- Civil procedure: the relevance to NPL sale of ongoing civil, enforcement, bankruptcy or other relevant procedures before courts and state authorities;
- Data privacy regulations, including but not limited to those concerning consumer rights;
- Taxation treatment of the sale of NPLs, with a particular emphasis on the incentives or disincentives which this creates for NPL sale;
- Accounting issues, including provisioning;
- Impediments that concerns foreign entities (FX Law) as well as any related taxation features;
- Review of impediments and framework for investors to inject fresh new capital (loan/equity) into troubled companies;
- Basic insight on the features that banks, as major holders and therefore potential sellers of NPLs, might be taking into consideration from the business point of view and in light of the existing Serbian regulatory framework.

2.3 Typical NPL sales transaction

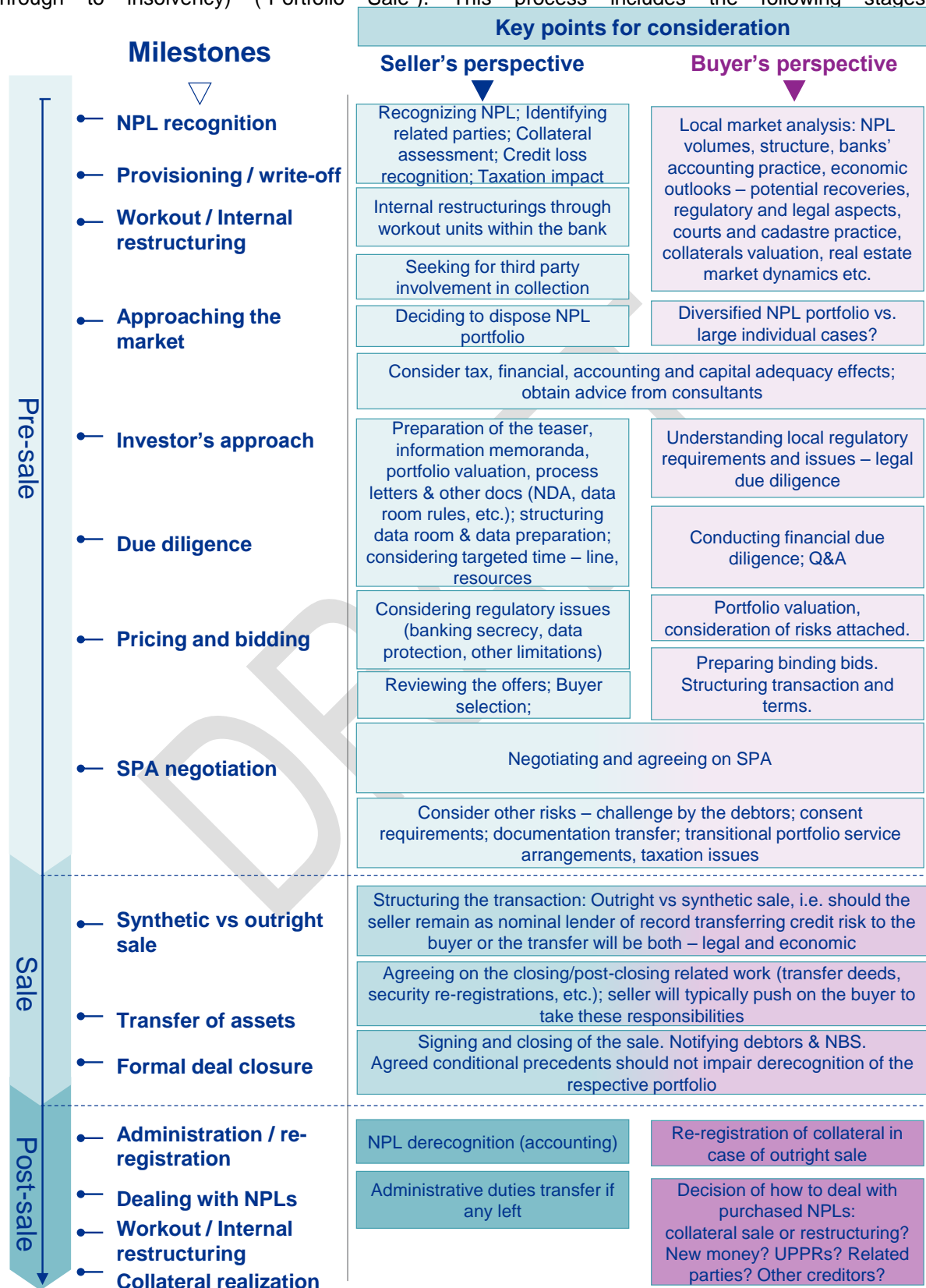
Based on our experience, successful NPL transaction should be conducted in a streamline process with several work streams, such as portfolio due diligence, Q&A session and SPA drafting, running in parallel.

The efficiency of the transaction itself depends on the banks' readiness for the process and the quality of information available. As a prerequisite for the successful and efficient transaction, banks need to have excellent and comprehensive prepared data and the prepared data room with all necessary documents and information relevant to the investor.

In case above explained reasons are fulfilled, it usually takes up to three months to complete the entire process, completing by signing the SPA and closing in the following month.



This following is an example of a typical NPL transaction whereby a bank ("Seller") intends to transfer a selected NPL portfolio – that comprise loan receivables, unsecured or secured by various collateral governed by Serbian law and are at varying stages of the work-out cycle (from cash-generative through to insolvency) ("Portfolio Sale"). This process includes the following stages:



3 Pre-sale

3.1 Existing regulatory framework governing transferability of NPLs

3.1.1 Transferability of different types of loans

Existing regulatory framework treats differently corporate and retail loans when it comes to transferability of NPLs.

Article 42 a) of the Risk Management Decision and Article 39 of the Financial Consumers Protection Act prescribe that a bank:

- may assign receivables under performing loans extended to any type of client (e.g. corporate or retail) only to another bank;
- may assign receivables under NPLs extended to a corporate client, entrepreneur and farmer both to another bank and to another legal entity (e.g. SPV, AMC);
- may assign receivables under any loan (i.e. irrespective whether it is performing loan or NPL) extended to a natural person as a retail client / the financial consumer (*fizičko lice – korisnik finansijskih usluga*) only to another bank. In this case, a natural person debtor retains all agreed rights in relation to the assignee bank that he had in relation to the original bank, including the right to complaint, and the assignee bank may not place the consumer in less favorable position than the position he would have if the claim had not been assigned and the consumer may not be subject to additional costs as a result of the assignment.

Article 42 a) of the Risk Management Decision. According to the amendments to the Risk Management Decision (applicable as of 1 December 2013), the transfer of a NPL portfolio is subject to advance reporting procedure before the NBS. Prior to making a decision on the planned assignment, a bank must assess (the "Assessment") the effect of the assignment to its:

- credit risk-weighted assets, reserves for estimated losses and capital adequacy ratio;
- NPL's amount and structure;
- expenses and financial result;
- risk profile.

Also, instead of the previous five days ex-post notification to the NBS, as of 1 December 2013, there is a requirement of **30 days ex-ante notification to the NBS** with regard to the planned assignment¹. A bank must deliver various documents to the NBS together with this notification, including:

- decision of its governing body on the assignment;
- main data about the person to which the bank intends to assign the receivables (business name, seat and registry number, as well as information on the ownership structure and members of the governing bodies), with an indication on whether the person is related to the bank;
- results of the Assessment;
- draft agreement on assignment with the planned date of agreement conclusion and/or execution²;
- data on gross book value of receivables to be assigned and the amount of value adjustment for those receivables;
- data on whether the assignment shall be performed against payment of fee, the absolute amount of that fee and/or percentage of the value of receivables to be assigned less value adjustment, and information on whether the bank is ensuring the funds for the fee payment directly or indirectly.

And finally, the bank must also ex post notify the NBS of the completed assignment by no later than five days following the assignment.

Therefore, these acts represent an impediment to the NPL market in the following:

- According to the Financial Consumers Protection Act, bank may not assign its claims (performing as well as NPLs) against natural persons to any legal entity other than a bank;
- Advance notice to the NBS of 30 days and requirement to prepare and deliver to the NBS the Assessment and various other documents complicates the NPLs sale process, which is also a logistics and cost burden;
- Sometimes banks are deploying a "Group of Borrower" approach with an intention to transfer its entire exposure against a particular corporate group. If certain members of the group are duly performing its obligations, loans extended to such entities may not be included into the portfolio (together with NPLs) which bank intends to dispose.

¹ Exceptionally, in the event of urgency, when the assignment of receivables is necessary for improving a bank's financial position, the bank may request from the NBS the approval that it submits to it the notification and required documentation within the deadline shorter than 30 days, but not later than five business days before conclusion of the assignment agreement.

² If the bank changes the planned date of conclusion and/or execution of the agreement after the notification to the NBS, it must inform the NBS of the change without delay.

Liberalization of the retail loan market

Liberalization of the retail loan market can be obtained by taking two courses – full liberalization, i.e. allowing sale of retail receivables to institutions outside of the financial sector or permitting transfer to financial institutions other than banks that are not as strictly regulated by the supervisor (e.g. lower capital requirements, lower or no capital adequacy requirements, etc.).

However, the latter implies the existence of diversity of financial institutions in the financial sector. Successful examples of NPL resolution achieved in this way can be seen in Austria and Germany, where retail NPLs remained within the financial sector, but with financial institutions that are not as strictly regulated by the banking supervisor in comparison to banks.

On the contrary, as further elaborated, resolution of NPL in Romania was driven by allowing unregulated entities to purchase retail NPLs, which proved to be a first step for what today is a successful example in the region.

Liberalization of the retail NPL market is particularly important first step for boosting the NPLs market because, based on the comparable experiences in other jurisdictions, it is expected that the investors will first test the market by purchasing smaller unsecured retail loan portfolios before they decide to invest in larger much complex corporate portfolios.

For example, in 2009 – 2012 the Romanian market was limited to smaller deals concerning unsecured retail loans, which was first step to investors to get acknowledged with judicial system and related risks. After this initial step, starting mid-year 2013, boosted also by a more general consolidation trend in the Romanian market, larger secured and secured corporate NPL sales began to occur. Only after ensuring solid and continuous smaller NPL transactions at first step, the Romanian NPL market started to consolidate.

Irrespective of whether NPL is due by a retail or corporate borrower, licensing requirements are removed with respect to loans that qualify as "loss" and related receivables (i.e. NPLs), which may be assigned to unregulated entities (with an exemption for certain specific types of mortgage backed NPLs regulated by a *lex specialis* for special type of real estate financing and retail mortgage backed loans that have been subsidized by the Government under the "first home" / "prima casa" program). In any event, an acquirer of loan receivables may service and collect the acquired receivables itself or via an appointed agent, as servicing and collection do not carry licensing requirements in Romania.

The similar approach should be followed in Serbia as well. In a first step, retail NPL market should be opened for all types of investors as this is expected to boost the overall secondary debt trading market in first period. Later, in a second step, when the market starts to function, it could be considered addressing possible market deviations by stricter regulations, e.g. prescribing that

mortgage backed retail NPLs may be transferred only to regulated entities such as factoring companies, financial leasing, insurance companies, etc. Additional arguments for allowing transfer of retail NPLs outside banking sector are as follows:

- Banks in general have rather conservative loan loss provisioning policies when it comes to retail NPLs, specially unsecured, thus based on our experience from other markets the gap in pricing expectations between potential sellers and buyers is rather wide and difficult to negotiate;
- Banks in principle have very bureaucratic and legally oriented approach when it comes to collection of past due loans, which is existing environment is usually ineffective, lengthy and expensive, as opposite to professional debt collection agencies / asset management companies, who have rather practical collection approach usually avoiding in-court processes and focusing on direct settlement negotiations with consumers, with more capacity and flexibility at the same time. Therefore, transfer of retail debt outside banking sector to professional debt collectors should have wider positive effects through: freeing up courts from number of related proceedings initiated by banks and reducing overall legal costs; freeing banks' collection and work-out capacities so they could focus on monitoring and soft-collection and larger complex NPLs cases; consumers themselves can benefit from flexible direct settlement negotiations with debt collectors as opposed to lengthy and expensive legal proceedings with banks.

There are few reputable entities specialized in retail debt collection already existing on the market (with practical experience from the period before the Financial Consumer Protection Act was adopted), so realization of first NPL sales transaction is expected immediately if the law is amended.

Financial Consumers Protection Considerations

We have acknowledged that the key rationale behind limiting transfer of NPLs related to natural persons outside the banking sector is to prevent risk of misconduct by “unregulated entities” (entities outside supervision authority of the National Bank of Serbia) towards individual borrowers.

According to the OECD's *Effective approaches to support the implementation of the remaining G20/OECD high-level principles on financial consumer protection*, there are two major solutions when it comes to prevention of such risks in jurisdictions in which certain products and services are provided outside the original sector – industry (e.g. financial services provided by the unregulated non-financial entities):

- (a) Assignment of roles and responsibilities among regulators or supervisors may follow a functional rather than a market or product approach. In such cases, the responsibility for consumer protection issues lies within single consumer protection agency (e.g.

Romania). This approach can facilitate the development of over-arching and cross-sectorial market conduct regulation/supervision that addresses gaps and overlaps, and promotes the coordination of emerging risks and consumers challenges across sectors and where necessary, co-ordination with relevant authorities to deal with cross-cutting consumer protection issues.

- (b) Licensing and/or registration of relevant services providers under separate type of regulated companies (in this particular case e.g. asset management companies, debt collection agencies, small credit institutions, etc.) and the supervision thereof help to mitigate the risks of fraud by non-regulated/non-registered or non-supervised entities.

Effective consumer protection system should protect all consumers from misconduct, irrespective of industry, service or product.

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3.1.2 Other legal considerations – contracting

NPL transactions are also covered by the provisions of the Obligations Act (Official Gazette of SFRY nos. 29/78, 39/85, 45/89 and 57/89; Official Gazette of FRY nos. 31/93, 22/99, 23/99, 35/99 and 44/99) as follows:

- **Article 436 Paragraph 1 of the Obligations Act** – Creditor (i.e. assignor) may, by conclusion of an agreement with third party (i.e. assignee), transfer its claim to the assignee provided that (i) transfer of the claim is not forbidden, nor (ii) nature of claim is such that it is not assignable (*intuitu personae*);
- **Article 436 Paragraph 2 of the Obligations Act** – Assignment agreement has no effect towards the underlining claim debtor if the debtor and the assignee have agreed that the assignor may not assign the claim to a third party or that it not may assign the claim to third party without debtor's consent;
- **Article 437 of the Obligations Act** – Accessory rights (such as the right of preferential payment, mortgage, pledge, rights on the ground of contract with a guarantor, rights to interest, to liquidated damages, and the like) will pass with the claim to the assignee. However, assignor may hand over pledged asset to assignee only if pledger consent to such handover, otherwise the creditor keeps the pledged asset for account of assignee;
- **Article 438 of the Obligations Act** – For claim assignment underlining debtor's consent is not required, however assignor is obliged to notify the underlining debtor about claim assignment. Fulfilment of assigned claim that occurred prior to notification is legally valid and releases the underlining debtor of its obligation, provided that it did not know about the assignment, otherwise the claim is not deemed fulfilled and the debtor is obliged to fulfil the claim towards the assignee.
- **Article 400 of the Obligations Act** - Contractual provision providing that interest will be calculated on due interest (*kamata na kamatu*), if not paid, is void. However, the respective prohibition is not applicable to loans advanced by banks and other banking organizations e.g. leasing companies.

These provisions represent an impediment to the NPL market in the following:

- **Scope of assignment** – The Article 436 Paragraph 1 provides only for assignment of claims, while transfer of contractual obligation (*ustupanje ugovora*) is regulated in by different provisions of the Obligations Act (Articles 145 to 147). Strictly speaking, besides the main obligation of a bank under the bank loan (obligation to lend money), bank also owes to a borrower certain concomitant obligations, mostly of administrative nature (e.g., to provide interest calculations, generating and processing information regarding indebtedness etc.). In practice, such technical and administrative obligations of a bank may case an issue in case of assignment of receivables, as assignor (bank), upon assignment, would not completely exit the relation with its borrower,

thus demanding its further involvement and need for mutual regulation of servicing relation between assignee and assignor for containing provision of administrative and technical services;

- **Non-assignment clause** – Assignment of NPL has no effect on the underlining debtor if debtor and assignor have agreed that the assignor is not entitled to assign the NPL or to assign it only with debtor's consent (provided that the debtor does not provide such consent). Therefore, non-assignment clauses may effectively prevent valid assignment of NPLs. Indeed, it is extremely rare that bank loans contain a clause which prohibits the lender (bank) to assign its receivables. However, in some very large loans with investment grade borrowers, this possible which makes that loans non-tradable without consent of a borrower;
- **Handover of asset pledged via possessory pledge** – Assignor keeps possession of pledged asset for account of assignee, unless the pledger/underlining debtor provides consent for pledged asset handover. Although possessory pledge as such in accordance with the Obligations Act is now rarely seen in commercial transactions (i.e. non-possessory pledge pursuant to the Secured Transactions Act is by and large predominant security instrument when comes to movable and intangible assets), it should not be entirely neglected. Namely, a pledge over shares issued by Serbian joint stock corporations (*akcionarsko društvo*), as it is regulated by Operating Rules of the Central Securities Depository and Clearing House (*Pravila poslovanja Centralnog registra za depo i kliring hartija od vrednosti*) and understood by the Securities Exchange Commission (*Komisija za hartije od vrednosti*) in its opinions³, basically relies on the concept of the (possessory) pledge of the Obligations Act. Further, expected developments of agri-financing industry may also create demand from some lenders for certain variations of the possessory pledge (e.g. some types of the so called "field warehousing" arrangements). In all these examples, the pledger could theoretically invoke Article 437 paragraph 2 of the Obligations Act and claim that its consent is needed for actual delivery of the possession over the pledged asset (or control in respect of the pledged shares / financial collateral) to the assignee / new creditor.
- **Different interest rate rules applicable if banks or other banking organizations are creditors**
 - Investors, not being banks and other banking organizations, will not be able to benefit from the exemption which allows that interest may be calculated on due interest (*kamata na kamatu*).

3.1.3 Solutions and recommendations

High priority recommendations:

- i. Certain obligations of respectively banks and their borrowers not automatically**

³ See, for example, the following opinions:

- (i) Opinion number 3/0-04-621/2-05 dated 27 October 2005
http://www.sec.gov.rs/index.php?option=com_content&task=view&id=286&Itemid=170
- (ii) Opinion number 2/0-03-105/3-09 dated 12 March 2009
http://www.sec.gov.rs/index.php?option=com_content&task=view&id=898&Itemid=164

transferred with the assigned claim - Amendment of the Obligations Act and/or the Banking Act by which obligations inherently tied and directly related to the assigned bank NPL would also be, automatically, transferred together with NPL receivables. For example, this question had to be resolved in Romania by courts. Therefore, in order to preclude court litigation cases, the rule should be clearly stated in the law adopted by Parliament.

- ii. **Inability of charging of "interest on due interest" by non-banking buyer** - Amendment Article 400 Paragraph 4 of the Obligations Act so to include explicitly the legal successors of banks in relation to transferred NPLs will provide them with the benefit from the statutory exemption which allows that interest may be calculated on due interest (*kamata na kamatu*). This would increase the attractiveness of the NPL market by allowing debt investors to charge additional interest and create an even playing field between investors – both banks and non-banks.
- iii. **Non-assignability of retail NPLs outside of banking sector** - Amendments to the Financial Consumers Act and the Risk Management Decision in order to explicitly allow that NPLs with financial consumers (i.e. natural persons) may be assigned to a non-banking and non-regulated entity.
- iv. **Non-assignability of performing (corporate) loans outside banking sector** - Amendments to the Financial Consumers Act and the Risk Management Decision in order to explicitly allow, in very specific cases, that performing loans advanced to a borrower belonging to the same group as the non-performing borrower may be assigned to a non-banking entity; The idea behind is to allow easier resolution of cases such as large distressed borrowers groups, where still some loans are undue and considered as performing by some creditors and in such way attract NPL investors to acquire such complex cases;

Other recommendations:

- In order to facilitate a more efficient NPLs sale process, it should be considered that the procedure provided for in Article 42 a) (i.e. at least Paragraphs 4 to 7) of the Risk Management Decision is simplified or revoked.
- Transfer of entire portfolio. Although the Obligations Act recognizes bulk sale of assets (*prenos imovinske celine*), transfer of NPL portfolio should be regulated by the Banking Act. The Banking Act should explicitly recognize a "portfolio transfer" concept (*prenos portfelja*), i.e. allow that a bank may sale its entire NPL portfolio or a portion of this portfolio within one transaction. For example, portfolio transfer is already explicitly allowed for insurance companies under Articles 222 – 226 of the new Insurance Act (*Zakon o osiguranju*) (Official Gazette of RoS, no. 139/2014));
- Clarification in the Banking Act that bank-client relationship is not *intuitu personae* and that

due receivables are transferable;

- *Amendment of the Obligations Act by which the non-assignment clause is ineffective in case of bank's NPL assignment. The same question was also relevant for the factoring industry and the Serbian Factoring Act (Zakon o faktoringu) (Official Gazette of RoS, no. 62/2013) opted for the market oriented solution advocated herein by explicitly providing in its Articles 30 and 31 for ineffectiveness of non-assignment clause for purposes of factoring;*
- *Amendment of the Obligations Act by providing that, in relation to bank NPL assignment, it shall be deemed that pledgor has provided its consent to handover to assignee of asset pledged via any kind of possessory pledge. Rules should be clearly in favour of full and effective transferability of the collateral, regardless of its type, so as to preclude unnecessary complex litigations and hindrances to the NPL market.*

3.2 Banking and data secrecy matters

3.2.1 Banking secrecy

The following paragraphs reflect on the legal perspective of NPL transactions taking into consideration the current legislation on banking secrecy and data protection.

Banking act has regulated banking secrecy issues in its following articles in the following manner:

- **Article 46 Paragraphs 1 and 2 of the Banking Act** – Banking secret is business secret. The following are deemed as banking secret:
 - data known to a bank relating to personal data, financial status and transactions, as well as to ownership or business relations of clients of such bank or another bank
 - data on balances and flows on individual deposit accounts;
 - other data obtained by the bank in operation with client.
- **Article 46 Paragraph 3 of the Banking Act** – the following are not deemed as banking secret;
 - public data and data accessible from other sources to interested persons with legitimate interest;
 - consolidated data that do not disclose individual client identity;
 - data on bank shareholders and the amount of their participation in the bank's share capital, as well as data on other persons holding participation in the bank and data on such participation, regardless of whether they are the bank's clients;
 - data relating to due performance of fulfilment of client's obligations towards the bank;

- and finally, unless otherwise prescribed by any specific law, client data considered a banking secret may be disclosed to third persons only upon receipt of written consent from the client.
- **Article 47 of the Banking Act** – Bank and members of its corporate bodies, shareholders and employees, as well as external auditor and other persons who due to nature of their work have access to information to banking secret, may not disclose such information to third parties nor use them against interest of bank or its clients, nor may they enable access to such information to third parties.

Relating to the above explained, the following impediments have been identified with respect to the NPL market development:

- **Broad definition of banking secret** – Definition of banking secret, without exception, encompasses all information known by a bank that relates to its client;
- **Limited exceptions to banking secret no disclosure obligation** – Banks are entitled to disclose information deemed as banking secret to their parties only if a bank's client to whom the banking secret relates provides prior written consent. Other exceptions to non-disclosure rule mainly pertain to cooperation with local and national authorities. Namely, exemption that the bank may disclose "data relating to due performance of fulfilment of client's obligations towards the bank (*podaci koji se odnose na urednost ispunjavanja obaveza klijenta prema banci*)" is not regarded as a clear-cut exemption for information about clients under NPL portfolio. Namely, due to vagueness of the black letter law, courts may limit the scope of this exception in their practice.⁴ For example, Romanian law also does not contain an express exemption from banking secrecy and data protection in relation to transfers of NPLs. In respect of professional (banking) secrecy limitations incumbent on credit institutions and financial institutions, specific information in relation to loan receivables and debtors may be disclosed in certain limited scenarios only, including for "legitimate interest" of the disclosing party. In the absence of any specific guidance by Romanian law on what constitutes a "legitimate interest", the Romanian courts have taken the view that disclosure of specific information subject to secrecy rules should be avoided during due diligence stages if a bank is selling its NPL portfolio or if the entire bank is subject of a sale.

⁴ For example, Austrian Supreme Court in its judgment of 26.11.2012 resolved that assignment of loan receivable is null and void because of violation of banking secrecy, if assignment is made (i) without explicit customer consent; (ii) unless final judgment obtained for loan receivables; or (iii) unless assignment is made to another entity which is subject to banking secrecy (by statute; e.g. securitization SPVs); or (iv) unless overriding interests of the credit institution accepted under the Austrian Banking Act prevail.

3.2.2 Personal data protection

The data protection act has regulated data protection issues in its following articles as set out below:

- **Article 3 Paragraph 1 of the Data Protection Act** – Personal data is any information that relates to natural person, regardless of form in which it is disclosed, whose order, in whose name or account the information is stored, information date, place of storage, means of acquiring or other characteristics of the information;
- **Article 3 Paragraph 3 of the Data Protection Act** – Data processing is any activity undertaken in relation to data, such as: acquisition, recording, transcription, copying, multiplying, transferring, sorting, storing, dividing, cross referencing, disclosing, emitting, organizing, keeping, adapting, disclosing by transferring or otherwise disclosing, hiding, relocating or otherwise making it inaccessible, as well as undertaking other activities relating to data, regardless of whether undertaken automatically, semi-automatically or in another manner;
- **Article 8 Paragraph 1 Items 1 and 2 of the Data Protection Act** – Processing is not permitted if natural person has not provided consent for processing, or if processing it is undertaken without authorization provided by the law. Processing is not permitted in case its undertaken for different purpose than for which the consent was given, regardless of whether it undertaken on basis of law or consent, except if it undertaken for purpose of humanitarian cause.

Relating to the above explained, the following impediments have been identified with respect to the NPL market development:

- **Consent required for transfer of personal data from banks to NPLs acquirer** – Due to all-encompassing definition of data processing, banks may not transfer personal data to any third party, unless natural person to whom the data pertains, consent to such transfer;
- **Consent required for acquisition of information by NPLs acquirer** – acquisition of information by NPLs acquirers would be caught under data processing definition, thus natural person's consent is required for such acquisition;
- **New consent obligatory if data processing purpose changes** – Should the purpose for which NPLs acquirers process data be any different from the purposes for which banks undertake the same activity and for which natural person already provided consent, new consent of natural person would be required.

3.2.3 Solutions & recommendations

High priority recommendations:

- i. **Broad definition of banking secrecy with limited exceptions** - Supplementing the exceptions to non-disclosure of banking secret by clearly providing that information related to NPL portfolio and debtors thereunder are not subject to banking secrecy requirement and may be disclosed to interested third parties (e.g. potential bidders). This question had to be resolved in Romania by courts which have formed a practice that a bank has a "legitimate interest" to disclose information related to the NPLs in order to facilitate its sale. Therefore, in order to preclude court litigation cases, the banking secrecy exceptions for NPLs should be clearly stated in the Banking Act. The same exemption should also be provided for banking M&A transactions where purchaser is bidding for a significant or controlling qualified stake in a bank. Such disclosure should be made to an assignee/transferee under NPLs or bank M&A transaction only after putting in place appropriate confidentiality undertakings. If the NBS would wish to be informed and safeguard confidential information, a standard procedure with the NBS may be introduced i.e. the standard non-disclosure agreement (NDA) approved by the NBS;
- ii. **Inability of banks to process/transfer personal data of defaulting clients to third parties** - Carving out from definition of data processing: (i) transfers of personal data undertaken by banks to NPLs acquirers when banks transfer NPLs to NPLs acquirers and (ii) acquisition of personal data undertaken by NPLs acquirers when NPLs acquirers acquire NPLs from banks. Further, it should be considered that the Data Protection Act is amended so to provide that new consent is not required if purposes for which NPLs acquirers process personal data do not significantly deviate from purposes for which banks processed personal data. Disclosure should be made to an assignee/transferee under NPLs or bank M&A transaction only after putting in place appropriate confidentiality undertakings. A standard procedure with the Commissioner for Information of Public Importance and Personal Data Protection (Poverenik za informacije od javnog značaja i zaštitu podataka o ličnosti podneo) may be introduced i.e. the standard non-disclosure agreement (NDA) approved by the Commissioner in order to keep the Commissioner informed and to safeguard data protection.

The Banking Act should also be amended in order to provide an explicit permission to carry out due diligence of a NPL portfolio and due diligence of an entire bank (legal, tax, financial, technical due diligence) subject to non-disclosure agreement.

3.3 Pre sales taxation matters

3.3.1 Tax perspective – pre sales

In practice, certain tax provisions and especially the Tax authorities' interpretation of these provisions in the course of tax audit, has had a discouraging effect on the banks' decision-making process in respect of NPLs.

Tax related issues, which have been communicated by banks and potential investors, as having dissimulative effect on resolving issues concerning NPLs are related primarily to the following:

- Strict conditions for tax recognition of receivables write-off,
- Possible tax burden on debtor whose related party debts were released
- Personal income tax implications of write-off of receivables from individuals
- Inappropriate interpretations of the legislation by tax inspectors in the course of tax audits and especially incorrect interpretations of article 22a of Corporate Income Tax Law (CIT Law) (the provision regulates conditions for tax deductibility of receivables provisioning within banking sector).

Strict conditions for tax recognition of write-off of receivables

CIT Law prescribes the following conditions which need to be fulfilled in order a write-off of receivables is treated tax deductible (article 16 of CIT Law):

- 1) Receivables were previously included in the taxpayer's revenues (if under IAS and IFRS rules receivables are not treated as income, the first condition is not applicable);
- 2) Receivables are written-off in the accounts as uncollectable;
- 3) Taxpayer provides evidence that it has filed a lawsuit regarding receivables collection, or that enforced collection procedure has been initiated, or that the receivables are reported in the bankruptcy or liquidation procedure.

Furthermore, CIT Law defines adjustment of the tax base (i.e. increase of taxable profit) for the write off of receivables which were previously provisioned (without effect on P&L, i.e. write off of already impaired receivables) and where related expenses were treated tax deductible, in case above stated conditions are not fulfilled in the period in which write-off of such receivables takes place.

The above mentioned provision besides being administratively burdensome, has the following two inefficiencies as well:

1. Write-off of receivables where previously provisions were made and where these provisions were not treated tax deductible remain permanently non-deductible (even if above noted conditions for deductibility of expenses in relation to write-off are fulfilled);
2. Expenses in relation to write-offs of receivables towards entities entering UPPR are not recognized for tax purposes.

It is our opinion that current tax treatment of write-off of receivables is superseded. Namely, from the accounting point of view, no material difference exists between write-off and provisioning for impairments, and an entity is allowed to choose the actual accounting technique freely. Consequently, it can be argued that current rules treat the same accounting concept differently depending on the technique for presentation an entity opted for. In our view, write-off is an accounting technique which is aimed at fairly presenting expectation of very low possibility of recovery, and does not mean that an entity gave up on its effort for collecting recoverable amount.

Possible tax burden on debtor

Accounting treatment for debtors whose debts are released depends on whether the former lender is a related party. Release of debt in debtor's accounting records is posted as revenue if the lender was a non-related party, while if lender was a related party the debt release would be posted as equity.

In accordance with the applicable legislation (The Property Tax Law), gift tax is payable on any receipt (including debt release) which is not recognized as revenue in the income statement. Therefore, gift tax at the rate of 2.5% is payable on debt release not posted as revenue in income statement.

In our opinion, applicable provisions unequally treat capital contributions depending on the form they occur. Namely, capital contribution made in cash, as well as debt to equity conversions are considered tax neutral events. In our view, a debt release from a related party is in substance identical to debt to equity swap, but the tax treatment is different.

In this respect, we recommend that exemption from gift tax in the Property Tax Law includes a debt release notwithstanding how debt release is accounted at a level of debtor. This would equalize tax treatment of capital increases regardless of the form how specific capital increase is executed (contribution in money, contribution in kind, debt to equity swap or debt release between related parties).

Personal income tax implications

According to the Personal Income Tax (PIT) Law and available practice, write-offs of receivables from natural persons are considered other income of individuals, if the bank did not fulfill prescribed CIT conditions for tax deduction of write-off expenses. The amount of write-off for persons not employed with the relevant bank is subject to tax on other income, at the effective rate of 16%.

In our view, above explained tax treatment of write-off represent an important impediment to efficient development of NPL market. Please note that the write-off of receivables for accounting purposes does not represent formal legal debt release (the legal claim from the person still exists). Therefore, from a legal perspective banks did not provide any benefit to natural persons and therefore no personal income tax should be payable before the bank forgives the debt legally. Additionally if amendments of CIT Law in respect to tax treatment of impairment expenses are amended, the amendments of PIT Law will be necessary in order to achieve a comprehensive framework based on the same principles.

Misinterpretation of the CIT Law provisions

As noted above the Serbian tax legislation, apart from two provisions noted above, does not deal specifically with the issue of NPL. The rules are rather general, administrative burdensome and often ambiguously interpreted in practice, especially in the course of tax audit. An example of misinterpretation of applicable rules is provided below. In past several years, this particular example has been constantly noted by the whole banking sector as serious impediment to recognition of adequate level of impairments in respect to NPL:

In the previous period, article 22a of the CIT law defined as tax deductible “Increase of provision for receivables and estimated loss provisions in relation to off-balance sheet items, at a level of Bank, **up** to the amount defined in accordance with the regulations of the National Bank of Serbia (NBS)”. The recent changes of CIT Law clarified this provision in a manner to clearly state that increase of provisions for receivables and estimated loss provisions in relation to off-balance sheet items at a level of Bank, are deductible if done in accordance with internal acts of the Bank (which needs to be aligned with IAS/IFRS) and NBS rules (which also prescribe that receivables impairments and loss provisions for off-balance sheet items should be done in accordance with IAS/ IFRS).

Namely, NBS regulations require from banks to recognize receivables impairment and estimated loss provisions in accordance with the IAS/ IFRS. However, the Decision on the Classification of Bank Balance Sheet Assets and Off-balance Sheet Items (“Decision“) also obliges banks to calculate the amount of reserves in accordance with the methodology particularly provided for this purpose. Reserves for estimated losses are calculated for the purpose of determining capital adequacy only. It is crucial to note that this methodology is not used for recognition of reserves/ expenses in financial

statements of banks and should not be used in any case as a reference point for tax deduction of receivables impairment expenses.

The Tax Authorities in several audit cases incorrectly interpreted article 22a of CIT Law which resulted in higher CIT liabilities for audited banks although banks adequately recognized impairment expenses. Even with the recent changes where CIT Law clearly stipulates that provisioning done in accordance with internal acts of the Bank (i.e. which needs to be aligned with IFRS/ IAS) and NBS rules (which also refer to IFRS/ IAS when impairment expenses are concerned), there were cases where the Tax authorities made reference to NBS rules for calculating reserves instead of NBS's rules for recognizing receivables impairments.

Above mentioned uncertainty resulted in several banks taking more conservative approach when recognizing expenses in relation to receivables impairment and loss provision for off-balance sheet items.

As described in previous sections of this report, tax legislation is quite general and does not provide with comprehensive set of rules that regulate the sale of NPL. However, from CIT perspective the sale of receivables is adequately regulated. Also recent changes of VAT Law introduced reverse charge in case of enforced sales when enforced sale is made to a VAT registered buyer. This provision is specifically important during the NPL work-outs (conducted by banks or the buyer of NPL's).

Comments on the newly adopted amendments of the CIT Law and PIT Law

CIT Law

The MoF prepared amendments to the CIT Law which were aimed at removing tax impediments to creation of NPL market in Serbia. The amendments came into force on 1 January 2016.

In our view, amendments are not substantial in nature, since most of previously identified impediments remained unresolved.

Namely, amendments still predict strict general conditions for tax recognition of expenses for write-off of receivables for industry sector. However, according to the amendments, provisions that were not previously treated tax deductible will be treated deductible (once general conditions for deductibility of expenses in relation to write-off are fulfilled) and some of previously unregulated situations like deductibility of claims in UPPR procedure are addressed.

Nevertheless, it is not clear if these provisions apply to banks as well. Namely, adopted amendments introduce specific rules for recognition of write-off expenses for banks (i.e. specific conditions). Namely, expenses from the write-off of individual loan receivables from unrelated parties will be considered tax deductible if more than two years from the loan maturity have elapsed

and that the bank provides evidence of debtor insolvency. It is not clear whether a bank can apply general rules for recognition of write-offs of receivables as tax deductible if it is more favorable than two-year rule.

This could discourage banks to make write-offs following primarily accounting principles. In addition, the request that the bank provides evidence of debtor insolvency is rather general and unclear, subject to different interpretation in practice.

Furthermore, paragraphs 9 and 10 of article 16 do not take into account introduction of specific rules for deductibility of write off of loan receivables. Hence, it could be concluded that in certain circumstances, the Bank should fulfill both the general and specific conditions in order certain write off is considered tax-deductible.

Finally, our major concern arises from the fact that amendments still treat equally accounting write-offs and formal legal debt releases. As mentioned previously, accounting write-off is just one alternative for recognizing receivable impairments and in our view it should not be treated as a formal legal debt release.

Amendments to article 16a (tax deductibility of losses on the sale of receivable) precise that the existing rule should be applied at the level of individual receivable. It is not quite clear what is the purpose of defining that the rule should be applied at the level of individual receivable. Please note that one of the goals of the strategy is to encourage the sale of portfolio. Therefore, reference to individual receivable should be reconsidered in our view.

Further amendments of the article 16a clarify that previously recognized receivables impairment expenses (write-off/ provisions) remain recognized in the case of sale of those receivables. However, amendments do not prescribe recognition of impairment expenses which were previously unrecognized at the moment of sale of those receivables. Therefore, current article 16a should be amended to include a provision which will allow that previously non-deductible impairment expenses are recognized for tax purposes at the moment of sale of receivables.

PIT Law

The amendments of the PIT Law prescribe that write-off of receivables towards individuals will not constitute a taxable benefit provided conditions for CIT recognition of write-off of receivables are met. In our opinion, these amendments are not substantial in nature and still treat accounting write-off as formal legal debt release.

3.3.2 Solutions and recommendations

High priority recommendations:

- i. **Ambiguously interpreted rules for tax deductibility of bad debt provisions / write-off** - Amending CIT rules that regulate the deductibility of receivables impairment expenses for Banks (articles 22a and 16) i.e. defining those rules in a less restrictive manner may facilitate unbiased recognition of receivables impairments for accounting purposes and consequently facilitate the development of NPL market in Serbia.

As there is no difference in accounting treatment of provisions for receivables and write-offs of receivables article 22a of the CIT Law that relates to banks exclusively should be amended in a manner not to create a disincentive for banks to deduct expenses in relation to write-off of receivables..

Finally, it is our recommendation that special attention should be taken in harmonizing tax auditors' interpretation of existing and future rules with interpretations of Ministry of Finance.

- ii. **Strict requirements for write-off of receivables** - From the accounting perspective, IAS/IFRS prescribes principles how receivables impairments should be recognized. The mechanism how impairment expenses will be posted in accounts is not regulated i.e. recognition of impairment expenses may be conducted by conducting a direct write-off of receivables or by creating a provision account. From the accounting perspective write-offs of receivables and provisioning of receivables are treated as equal. Having in mind that, article 22a of the CIT Law should be amended in the following manner:

“Notwithstanding provisions of the article 16, receivable impairment expenses, posted either as provision or write-off, are recognized for tax purposes in the tax balance of a bank, if those provisions and write-offs were conducted in accordance with the internal acts of the bank and IAS/IFRS.

- iii. **Misinterpretation that write off equals debt release** - Write-off of receivables for accounting purposes does not represent formal legal debt release (the legal claim from the debtor still exists). Therefore article 22a of CIT Law should clearly stipulate that an accounting write-off does not represent formal legal debt release. In line with the above mentioned, the reference to the article 22a from the paragraph 7 of the article 16 should be deleted. Also, article 16a should be modified in a way which will allow for recognition of impairment expenses which were previously unrecognized.
- iv. **Treatment of receivable write-off for individuals as their private income** - Additionally,

from a Personal Income Tax (PIT) Law perspective article 85 paragraph 8 should be amended in a manner to clearly stipulate that formal legal debt release is taxable event and not write-offs conducted for accounting purposes. Furthermore, it is our opinion that currently available reliefs applicable for write-off should be allowed in case of debt release. Therefore, debt release should be exempted from taxation in the following cases:

- If the expenses of initiating court proceedings are greater than total face value of the receivables from the respective debtor
- In case of debt release made by the bank to the borrower who, based on the settlement agreement signed between that borrowed and the bank or based on any other collection procedure (e.g. enforced collection), sold the immovable property financed by the loan from the bank at price that may be considered market value and paid the total sale amount to the bank on behalf of loan repayment, but the paid-in amount is less than total face value of receivables the bank recognizes with respect to the loan granted, provided that according to NBS regulation that loan is classified as a loan for which 100% reserve for estimated loss is calculated.

Other recommendations

- Having also in mind our comments previously noted, it is our recommendation that particular care is devoted to clear and assertive communication with the Tax authorities that previously issued opinions are no longer valid and to ensure uniform application of the article 16a and 22a. Furthermore, article 16a should provide that loss from the sale of receivable is tax deductible regardless of the type of the transfer of receivable (synthetic or outright).
- No other taxes are applicable on the sale of receivables.
- However, please note that amendments of CIT rules regarding tax treatment of receivables write-offs/ provisions are the crucial precondition for tax efficient sale of receivables.

3.4 Commercial aspect - pricing gap

As already noted and further elaborated, bridging bid-ask spread is one of the largest impediments to development of the NPL market and more transactions. Bid-ask spread is caused one hand by investors' expectations and on the other side existing level of NPL provisioning.

Ideally, by removing identified impediments and by adopting successfully proven NPL resolution scenarios, would lead to more NPL transaction in the market and NPL resolution.

Investors' perspective

From the demand point of view, potential investors are facing many constraints that ultimately lower expected rates of return driving pricing decision in the negative direction.

These mostly consist of uncertain cash flows related to NPLs. They bear unknowns in two aspects – timing, driven by the liquidation of assets through court procedures having in mind most NPL clients are in serious distress and amounts, influenced by optimistic valuations and practically no real market data for real estate. Due to the fact lending in Serbia is almost entirely asset based, driven by the collateral value, there is high reliance on stagnant real estate market expressing low liquidity. Therefore, estimating real estate fair value is of extreme difficulty.

Adding up other factors like: an entry to new market environment, existence of unfamiliarity (new legal & judicial system, etc.), the fact that Investors need to establish a platform, i.e. local entity for work-out in order to create return on their investment, it is clear why bid prices have been at low levels.

Furthermore, seriousness of distress of most NPL clients leads therefore potential investors to long workout procedures, usually court related with, as they perceive, and low future cash flows due to lack of demand.

With investors facing unknowns in the market, being not fully familiar with all regulations and risks they face, they perceive that there is not enough security for their investment and restructurings, i.e. no binding and stable legal framework.

Potential investors require complete visibility of legal and regulatory system which will represent solid base and possibility for recovery and liquidation of purchased NPL portfolios and collaterals.

With growth overall in NPL market likely to continue, and most specifically in the region, it is likely that investors interest will increase, but also that there would be significant competition on the supply side.

Furthermore, we have witnessed asset quality reviews in the EU, strongly affecting banks and their balance sheets clean-up in the region, which already puts the region in the favourable position.

Also, due to high fixed costs of adopting to local regulations and the necessity of achieving economies of scale it is no surprise that investors' interest so far has been below expected in the Serbian market.

As previous experience and most recent transactions showed, investors seemed to be interested only into SME segment of especially fully written down loans. This seems to be reasonable having in mind relative simplicity and straightforwardness of that segment.

However, it seems that primary focus of the regulator as well as the government so far have been only complex corporate NPL cases that represent much greater challenge because of greater pricing gap due to insufficient level of provisioning at banks' side, high reliance on court procedures with uncertain and long lasting proceedings, dependence on low liquid real estate markets, etc.

Based on our experience and discussions with interested parties, investors, and especially those without experience in Serbian market would prefer to start with NPL transactions on less complex cases, such as retail and SME and then proceed to large corporate ones.

However, as further explained and elaborated throughout the study, due to the fact Serbian legislation has allowed only the transfer of corporate loans to entities other than banks, it seems that Serbian banking sector is facing slower and more difficult way to NPL resolution.

Banks' perspective

NPLs in Serbia, like in other countries in the region represent one of the main impediments to recovery from financial crisis.

However, from the local banks management perspective, having in mind strong capital and liquidity position due to lack of new projects and generally demand from money, there is no true incentive to sell NPLs.

Also it is clear that there is a significant gap in pricing expectations between banks and potential buyers.

However, the impact of NPL issue has a greater impact of the economy overall by trapping banks' resources, increasing costs of finance and having ultimate influence on investment activity in the economy.

Coverage of NPLs with impairment provisioning as at 30 June 2015 equalled 59.6% in Serbia. Recent success in NPL resolution in Romania has shown that NPL transactions started happening when provisioning levels reached the level of approximately 70% and above which obviously helped closing the pricing expectations between investors and banks.

As already elaborated, banks in Serbia are preparing their financial statements in accordance with IFRS, and have estimated reasonably their provisioning levels based within reasonable range of expectations.

However, levels of provisioning is based on over-stated collaterals, where due to as already explained, estimated prices do not represent market prices. Furthermore, the practice has shown that banks in the market do not properly account for all costs relating to internal NPL workout (costs of holding collateral, costs to sell, etc.), also being allowed by current regulation, not forcing banks to adjust collateral valuations.

We have understood that NBS intends to issue regulatory framework in the field of collateral valuation that will prescribe stricter rules for both – licensing of appraisers and affect valuation practice overall by complying it with international valuation standards.

Furthermore, it would be valuable if NBS, as a supervisor would issue guidance for small and medium banks, as well as those with insufficient historical and statistical data regarding parameters used in provisioning on a collective basis, such as PDs, LGDs, etc., but also haircuts and realization periods for the purposes of provisioning assessment on individual basis.

However, guidance should not, in any case represent a breach to the IFRS. An example of similar guidance has been introduced in Croatia recently. More precisely, Croatian National Bank has adopted the Decision on the classification of on-balance sheet exposure and off balance sheet items that prescribes ranges of impairment provisioning that should be applied to different categories depending on days past due on the day of assessment.

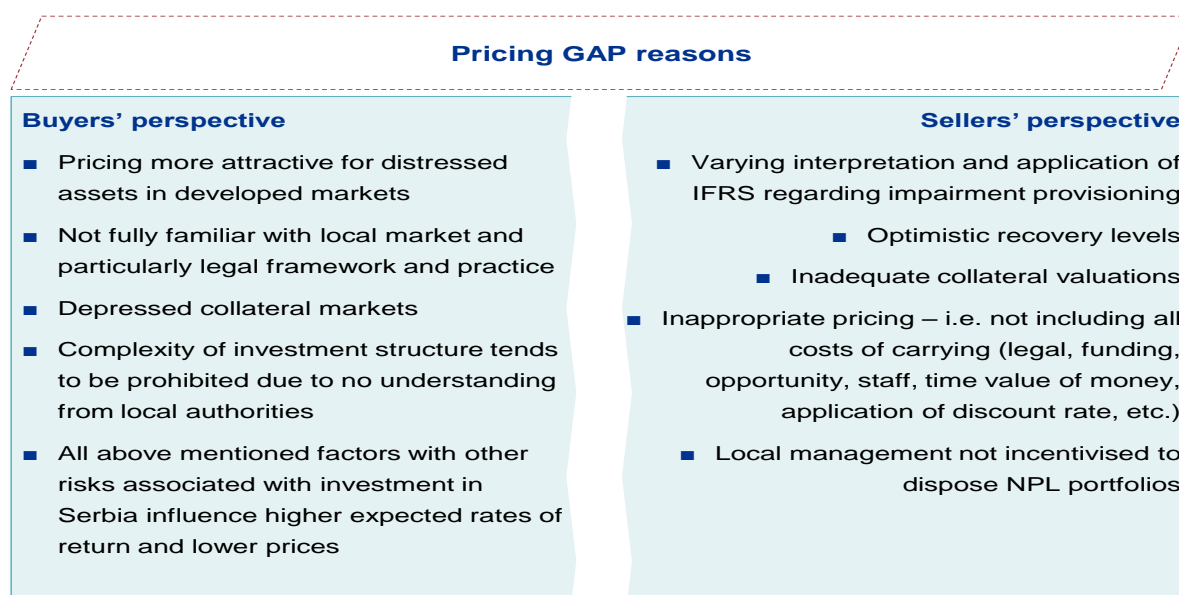
In our view, consistent and sufficiently prudent application of IFRS regarding loan loss provisioning and by narrowing the pricing gap, jointly with removal of existing regulatory impediments - would lead to further development of NPL market.

More important, empirically shown, this would lead to improved risk-taking from banks' side, increased lending capacity and would make a solid grounds for economic development overall.

3.4.1 Market's view

There are a number of other factors that must be taken into consideration and addressed before a successful loan sale market can be established in Serbia.

Bid-ask spreads



In a number of cases the bank's provisioning levels remains at the lower end of the acceptable range of provisions according to IFRS, taking into consideration expectations on future improvements in the real estate market and overall macroeconomic developments. Even though banks have established levels of provisions that they feel comfortable with from an IAS 39 point of view, debt investors see higher risks when pricing such loans, thus pricing gap arises. This is exemplified in the sale of Project Ariadne in 2014, a corporate and retail portfolio in Romania that was put for sale by the Bank of Cyprus. The bid-ask spread during the final bidding process between the bidder with the highest price and the seller's lowest acceptable price was too great, and the sale was withdrawn from market as a result.

However, this potential barrier can be mitigated with a well-informed seller who has been provided with a realistic expectation of portfolio pricing. As banks come under increasing pressure to resolve the NPL problem and adjust the provisioning to more adequate levels reflecting also the intention to sell this issue can be expected to gradually reduce. Inadequate levels of provisioning were a significant barrier to loan sales in the UK, Ireland and Spain in 2010 – 2012, but with an improving economic situation as well as further provisions being taken against the oldest and most problematic arrears cases, banks were able to bring book value to a level where a sale price would be acceptable.

It is also worth noting that as the number of sales in the market increases pricing levels will increase and discounts to real estate value will gradually fall as investors become more comfortable with a jurisdiction.

Servicing capacities

Servicing capabilities on the ground of the jurisdiction that a loan sale is conducted in is also an important consideration. Serbia, without an established loan sale market, lacks many of the international third party servicers and supporting infrastructure needed in order for buyers to actually realize value and manage the day to day servicing of the loan portfolios that they aim to purchase in Serbia.

However, local banks with servicing capabilities through their existing operations may be able to fill the gap and provide both servicing and local expertise to buyers who are interested in Serbia but are unfamiliar with the servicing landscape. International servicers may also be interested in moving into the Serbian market and establishing themselves as an early-mover into a new loan market, putting them into a favorable position should more successful loan sales follow.

3.4.2 Solutions and recommendations

High priority recommendations:

i. Varying interpretations of loan loss provisioning in accordance with IFRS – *The improvement of impairment provisioning practice in line with IAS 39 should be the key priority given reliance on often over-inflated collateral valuations. Guidance for impairment provisioning, having in mind that it would have to be in accordance with IAS 39, enforced by the supervisor could be a useful tool for reduction of gap in pricing expectations between buyers and sellers and thus boosting NPL market. It is our understanding that NBS is already working on such framework.*

ii. Inadequate collateral valuations - *Given that levels of provisioning are mostly based on over-stated collaterals, not representing market prices, i.e. not properly accounting for all costs relating to internal NPL workout (costs of holding collateral, costs to sell, etc.), etc.*

Announced MOF' regulatory framework in the field of collateral valuation that will prescribe stricter rules for both – licensing of appraisers and affect valuation practice overall by complying it with international valuation standards will affect more realistic collateral valuations, thus narrowing the pricing gap.

iii. Lack of adequate historical data in small and medium banks - *the issuance of a Provisioning Guidance, especially for small and medium banks, in cases where historical data is insufficient to support parameters used for collective and provisioning on the individual basis, should provide more adequate levels of provisioning, as these banks usually do not possess adequate internal statistical data. This guidance would suggest acceptable approach when it comes to calculation of e.g. PDs, LGDs, etc. for collective provisioning purposes, but also approach when it comes to discounts for collateral and periods of realization; we understand that the NBS is currently working on such guidelines.*

However, such guidance should not depart from IFRS requirements.

- iv. Insufficient historical data on collateral realization** - Having in mind that many banks often do not possess sufficient information on historical collateral realization to substantiate the discounts applied to collateral as well as the realization periods, guidance mentioned in 3.4.2. iii could be a potential solution to the issue. It is our understanding that NBS is currently working on such guidelines.

Other recommendations:

- **Debt Investors' Guide** – As above elaborated, a pricing gap, from the investors familiar with local environment point of view, exists due to either familiarity or awareness of existing risks in the legal system and heavy reliance on long lasting court proceedings which are addressed throughout the further chapters of this Study. This is ultimately reflected in aggressive pricing. On the other hand, buyers not acquainted with the Serbian market, the legal framework and risks connected with overall legal practice, also tend to misinterpret existing regulations which together with the “leap into the unknown” leads to lower pricing. Existence of concise “**Debt Investors' Guide**” could provide investors with a solid basis for getting to understand the environment and potentially reduce quantification of legal risks in their pricing.

4 Course of sales

4.1 Synthetic NPL sale vs. outright sale

4.1.1 Legal perspective

The following paragraphs reflect on the legal perspective of NPL transactions by comparing broadly defined legal structures available for the sale of NPLs.

Generally, two types of loan sales are seen in practice in developed NPL markets: true (outright) and synthetic transaction. While true, i.e. outright sales are very clear by their very meaning, under so called synthetic transactions, the economic risks and benefits are being transferred (economic ownership), while the seller remains the nominal lender of record (legal ownership). Both types of sales have one feature in common – they ensure the transfer of economic i.e. credit risk and related benefits. Synthetic sale is more flexible to perform in a way that there is no change in legal ownership of loans, so less demanding in terms of legal formalities and registrations. Thus, certain regulatory obstacles could potentially be overcome through synthetic sale. Synthetic sale is quite common in developed economies. Currently available structures for sale of NPL that are available in international best practice are:

- **legal assignment (cesija)** - Legal assignment as an outright sale of the loan claims is by and large the predominant mode for trading with loan claims. NPLs are transferred through legal assignment by transfer of creditor's claim from current creditor (i.e. assignor) to new creditor (i.e. assignee). Through legal assignment obligations of assignor are not transferred to assignee, thus they remain with assignor
- **transfer of contractual position (both rights and obligations) (ustupanje ugovora)** - In contrast to legal assignment where only claims are transferred, in sale structured as transfer of contractual position, transferor transfers both rights and obligations to transferee. Legal impediment that is characteristic to transfer of entire contractual position lies with rule that transfer of obligations may be performed only with debtor's consent (Article 145 of the Obligations Act). This is a reason why NPLs are almost never traded via transfer of entire contractual position.
- **synthetic transfer / sub-participation (in form of either (A) funded participation or (B) risk participation)** - Generally, synthetic transfers involve all situations where the original lender remains the lender of record and contractual party with the borrower, while the "buyer" (i.e. the sub-participant) agrees solely with the original lender to assume the risk related to the underlying loan. Synthetic transfers are typically performed either as funded participations or as risk participations (but there may be other methods, including credit derivatives structures):

Funded participation

- In funded participation structure funding contract is made between new and current creditor. New creditor participates in amount loaned to debtor (or portion of it) by paying to current creditor an amount equal to all or relevant portion of loaned amount. In return current creditor pays to new creditor an amount equal to all or relevant share of principal and interest received by it from debtor.

Risk participation

- Key difference between funded participation and risk participation is that in the latter, new creditor, at the time of participation agreement, promises to participate in amount loaned to debtor in certain circumstances (e.g. default by debtor). In this respect risk participation is akin to guarantee as it shifts (entire or in part) risk of debtor's default to new creditor and provides the new creditor with a right of subrogation if it pays to current creditor in lieu of debtor.

Common characteristic of all sub-participation arrangements is that the agreement between original and new creditor remains outside of underlining loan transactions (i.e. underlining debtor does not have to be aware of it) and does not create any legal relationship between new creditor and debtor, the consequence of which is that the debtor does not need to be notified, new creditor has no direct claims against debtor and current creditor remains lender of record, as well as nominally registered holder of security interest in the respective asset title registries. Therefore, these are the main reasons why should the buyer and the seller might wish to structure their NPL transaction in Serbia as a synthetic transfer:

- Firstly, given that the original lender nominally remains a lender of record, there is no need to register change of the secured lender in the Pledge Registry and, even more important, the Real Estate Cadastre. Due to poor legal infrastructure, such re-registration with the Real Estate Cadastre might be significantly protracted (probably even more than a year in case of an appeal, even frivolous, by the debtor). Under the sub-participation and related servicing arrangements between the original lender and the sub-participant, the original lender continues to receive proceeds from the synthetically transferred loan or conducts enforcement. The original lender then transfers the collected proceeds to the participant serving thus basically just as a conduit for collected cash flows. As regards bank's due receivables (NPL), the sub-participation agreement should provide that all risks and rewards (including cash flows) related to the respective NPLs are effectively transferred to the sub-participant thereby enabling de-recognition of such NPLs from the books of the bank (including regulatory capital relief) in accordance with applicable accounting and regulatory capital standards;
- Secondly, as discussed above, Serbian banks currently may not transfer by way of an outright sale (assignment) receivables from performing loans extended to any type of its customer (i.e.

corporate, retail, farmer, entrepreneur) and NPLs against retail clients to anyone but another licensed Serbian bank. Therefore, there is no reason why it should not be possible to transfer these portfolios by way of synthetic transfer to a non-banking entity, since from the customer's perspective, as well from the perspective of the current rules, the loan was not legally assigned and the lender remained the same i.e. the only contractual party of the underlying customer (borrower) is still its original bank (lender);

- Finally, the original bank may have a specific relationship with certain borrowers, and does not wish a borrower to know that the bank has decided to reduce its exposure towards that borrower.

However, regarding synthetic transfers, some issues arising from current regulations in Serbia should be taken into account. In accordance with the article 50 Paragraphs 1 and 3 of the Insolvency Act – Creditors with separation rights (izlučna prava) are persons that, based on real or personal right, has right to demand separation of certain asset from insolvency estate. With regards to that, following impediments exist:

- **Non recognition of sub-participant as creditor with separation right in case of current creditor's insolvency** – Considering that in sub-participation structure there is no true sale of claim but rather synthetic as current creditor remains the lender of record, new creditor would not be afforded separation right over claim which it has funded;
- **Uncertain regulatory capital relief.** However, synthetic transfers involve uncertain regulatory capital relief for the principal lender, i.e. the NBS might regard that a specific sub-participation arrangement does not achieve a transfer of credit risk and that the exposure to the debtor cannot be zero-weighted.

4.1.2 Financial/commercial and accounting perspective

With regards to all possible types of transactions, i.e. outright and synthetic sale, it is crucial to understand the necessary criteria that need to be fulfilled in order for the bank to derecognize NPLs in its financial statements. This analysis should be performed on a transaction by transaction basis.

As it is below explained, this issue is rather complex, having in mind the strictness of IAS 39 predefined criteria and the emphasis of substance over form in the review of derecognition criteria.

Simply said, the standard prohibits derecognition of NPLs in case risks and rewards (especially risks) have not been transferred to a purchaser.

Outright vs. Synthetic sale of NPLs – derecognition criteria comparative		
Key issues to be considered	Outright sale	Synthetic sale
1. Evaluating whether contractual rights to cash flows have expired	<ul style="list-style-type: none"> Not applicable for NPL transfer, i.e. cash flows have not expired yet, therefore NPLs are not derecognised because of the fulfilment of this criteria 	
2. Evaluating whether there is a transfer	<ul style="list-style-type: none"> The transfer of legal title should result in a transfer of all existing rights associated with the financial asset without any additional restrictions. This is the case with outright sale 	<ul style="list-style-type: none"> In case of synthetic sales, i.e. sales where there is no legal transfer of the ownership and where the entity retains right to receive cash flows with however the obligation to pay the cash flows to the investor, there is a transfer only if there is a pass-through arrangement:
2. a) Is there a pass-through agreement?	<ul style="list-style-type: none"> N/A 	<ul style="list-style-type: none"> There is a pass-through arrangement only if: <ul style="list-style-type: none"> There is no obligation to pay unless collected from the loan Bank cannot sell or pledge the loan or the collateral Bank needs to remit all cash flows it collects without material delay
3. Whether risk and rewards relating to the specific receivable have been transferred?	<p>Key consideration:</p> <ul style="list-style-type: none"> An entity derecognises a transferred financial asset if it has transferred substantially all of the risks and rewards of ownership of that asset. The risks and rewards analysis is performed by comparing the entity's exposure, before and after the transfer, to the variability in the present value of the future net cash flows from the financial asset. Risk and rewards needs analysis to be performed only between Bank and the investor – without considering contracts with third parties for hedging purposes (e.g. insurance). 	

However, in order for the synthetic transfer to fulfill its effect, i.e. derecognition criteria as defined by the IAS 39, all defined requirements, mostly the issue of risk and rewards transfer need to be fulfilled.

The international practice does not recognize one unique approach, or transaction type. All transactions should be subjected to an analysis as to whether all requirements have been met.

Accounting treatment and explanation of all steps in the derecognition analysis are elaborated in detail in Appendix.

4.1.3 Solutions & Recommendations

High priority recommendations:

- i. The current legislation does not explicitly recognize synthetic sale arrangements - Approach of the authorities to synthetic transfers in NPL market should be flexible and supportive, considering all existing obstacles in the market in the fields of processing re-registration requests, given that such arrangements do not involve registration of a new creditor with the competent registries.*
- ii. Not recognizing sub-participant as creditor under the insolvency – Given that a sub-participant is not recognized as creditor with separation right under current creditor's*

insolvency in the potential synthetic sale arrangement, amendment of the Insolvency Act so as to afford the status of creditor with separation right to new sub-participant under synthetic transfers of NPLs would affect creating attractive environment for NPL transactions. It is important to note that such carve out already exists in Serbian legal system, i.e. in case of insolvency of a custody bank, it is widely recognised that the assets it holds as a custodian do not form part of its insolvency estate;

4.2 NPL sales and Civil procedure

The following paragraphs reflect on the issues related to the civil procedure, i.e. the relevance to NPL sale of ongoing civil, enforcement, bankruptcy or other relevant procedures before courts and state authorities.

Civil procedure code, has defined in **Article 204** that a pending court case does not influence the validity of the assignment. However, according to the Civil Procedure Act, the new creditor does not automatically replace the original creditor. The new creditor may enter civil proceedings only if the debtor in the relevant dispute agrees. Civil proceedings may continue with the initial parties (i.e. with the original creditor), and in such case the new creditor may invoke and collect the receivables under a final court's judgment although he was not party to the relevant civil proceeding.

With respect to that, the following impediments to NPL market development were identified:

Conditional dispute step-in right - NPL acquirer's right to take over the ongoing dispute, regarding the NPL it acquired while it is subject of dispute, either as defendant or plaintiff, is conditional by consent of both existing plaintiff and defendant;

Judgment binding upon NPL acquirer – Even if the NPL acquirer has not joined the dispute concerning the NPL it acquired while it was subject of dispute, the judgment rendered in such dispute is effective towards such NPL acquirer (which in some cases may be desired solution if there is a servicing arrangement in place between the old and new creditor of the disputed receivable);

There is a risk that e.g. ongoing dispute can disrupt/delay desired regulatory capital relief and de-recognition of the loan in the books of the original creditor (bank).

Solutions & recommendations

High priority recommendations:

- i. **Inability of NPL acquirer to take over an ongoing dispute** - Amendment of the Civil Procedure Act so as to envisage unconditional right of NPL acquirer to step into all rights of the previous creditor just by notice to the court, i.e. to step in as a party to the dispute concerning the asset (i.e. NPL) that was ongoing when it acquired it without the need to seek consent from the counterparty.*

4.3 Transfer of NPLs to foreign entities

4.3.1 Legal perspective

The following paragraphs reflect on the legal perspective of NPL transactions taking into consideration the transfer of NPLs to foreign entities.

Current rules, as prescribed by the FX act represent impediments to cross-border NPL transactions:

- **Outbound transfer of local NPLs** – Assignment of cross-border receivables is strictly limited only to the cases permitted by the F/X Act (e.g. in its Articles 18(5), 20 and 33). Therefore, a local loan, entered into between Serbian bank and Serbian resident entity may not be transferred to an off-shore AMC;
- **Registration of cross-border loans with the NBS** – In case of cross-border loan transactions, the resident borrower is obliged to register the loan agreement with the NBS. Furthermore, any change of a loan without being previously registered with the NBS (meaning that the NBS has rubber-stamped the registration and awarded the registration number to a loan), causes practical inoperability of the loan since no funds may be wired in or out of Serbia based on it. Documents required for registering a cross-border loan (including a certified translation of the loan agreement into Serbian language) must be submitted to the NBS by a Serbian resident borrower via its local bank through which the credit/loan is disbursed (i.e. processed), within 10 days from the date the loan agreement is concluded;
- **Resident debtor may practically frustrate change of a lender** – Article 33 of the F/X Act broadly allows for a transfer of a cross-border loan if all of the following conditions are met: (i) transfer transactions are performed on the basis of: (A) an agreement made by all parties (i.e., the original lender, the new lender and the borrower) or (B) a borrower's statement confirming notification of the transfer; (ii) the above documents contain details of the parties, the underlying loan agreement, the currency and amount of transferred claims and debts; and (iii) the resident borrower (the only one with authority to do so) registers changes of the lender with the NBS (without this formal change, all Serbian commercial banks are required to refuse to make outbound transfers to the new lender).

Thus, a cooperative borrower is needed (i) when making a three-party agreement or issuing a required statement and (ii) when executing the NBS forms for registering a new lender of record. We have witnessed cases in practice where borrowers easily obstructed lawful changes of creditors. This hidden transfer restriction is blocking the free trade with cross-border NPLs and is a major obstacle to the development of a proper NPL market;

- **Limitations imposed for granting cross-border security by Serbian resident borrowers/guarantors.** Article 18 Paragraph 7 in conjunction with Article 23 of the F/X Act prescribes that a legal entity resident in Serbia may provide cross-border security interests over its assets and/or corporate guarantees only for a non-resident obligor which is majority owned by the Serbian resident security provider / guarantor. Further, when granting a cross-border guarantee, a resident must contract and obtain collateral instruments (*instrumenti obezbeđenja naplate*) from a non-resident obligor;
- **Broader scope of banks' credit activities than the scope of residents' credit activities** – Banks are entitled to grant credit and receive security for such credit from non-residents, while resident – legal entities may grant credit and receive security from non-resident only if such non-residents are majority owned by resident creditor. Such broader scope of bank's credit activity implies that banks may not transfer the credit arrangements (including NPLs) to residents – legal entities if such credit arrangements fall outside of scope of permitted residents' scope of credit activity, thus residents may not acquire NPLs granted to non-residents, unless such non-resident are majority owned by resident acquirer of NPL;
- **Non-residents' non-entitlement to acquire NPLs granted by banks to residents** – the Article 20 Paragraph 1 provides that non-residents may acquire claims against residents only if such claims are based on a cross-border credit arrangement. The F/X Act is silent in respect to non-resident's entitlement to acquire receivables against resident that are based on domestic credit arrangement. According to NBS's long standing interpretation of F/X Act, pursuant to which what is not explicitly permitted it is not permitted, the Article 20 Paragraph 1 does not permit non-residents (e.g. off-shore AMCs) to acquire bank's receivables against a Serbian resident debtor;
- **Limitation of repayment terms** – The F/X Act and supporting by-law⁵ rendered by the NBS provides for a general rule that cross-border facilities may be repaid by a Serbian resident borrower only after the expiration of one year from the date of its disbursement, and if drawn in tranches - after the expiration of one year from the date of the drawdown of each individual tranche. Further, the repayment in instalments may begin after the expiration of six months from the date of each drawing and may be made in only pro rata payments (instalments) until the loan is fully repaid. The law also

⁵ Decision on the Terms and Conditions of Using Foreign Financial Credits for Purposes Set out in Article 21, Paragraph 2 of the Foreign Exchange Act (*Odluka o načinu i uslovima korišćenja finansijskih kredita iz in-ostranstva za namene iz člana 21. stav 2. Zakona o deviznom poslovanju*) (Official Gazette of RoS, nos. 6/2013 and 74/2013).

provides for an exemption from the rule allowing Serbian residents (legal entities and entrepreneurs) to enter into a cross-border loan facility with a repayment term shorter than one year, for the purposes of financing the purchase, processing and production of agricultural products or financing exports of goods and services, but may not start repayment before the expiration of three months from the date of each drawdown on the loan;

- **Hidden obstacles to cross-border payments** – Current by-laws and guidelines⁶ issued by the NBS provide that a cross-border payment may not be effected if there is no a specific code (*šifra*) designated for such payments. Obviously, no code-book (*šifrarnik*) can capture all possible and conceivable legal grounds for lawful cross-border payments. Therefore, deficiencies of such code-books are practically hidden obstacles for cross-border payment operations;

Current practice in applying the F/X Act – Current practice of the relevant authorities is not in line with the best international practices and it is more of a legacy inspired with heavy state interventionism policies. Namely, the best practice should be that if a transaction is not explicitly prohibited by the F/X Act, it should be deemed permitted in accordance with main principle of contractual freedom proclaimed by Article 10 of the Obligations Act.

4.3.2 Tax perspective

Sale of loans to a legal entity registered abroad, if enabled by amendments of foreign exchange and NBS's regulations, will have the same tax treatment as described in section 3.3 of this report.

In this scenario, withholding tax may be payable in accordance with CIT legislation. Namely, Serbian CIT legislation prescribes that withholding tax is payable on any interest income paid to the foreign legal entity. Payer of interest is due to calculate, withheld, pay tax and submit a tax return.

Withholding tax is payable at 20% rate, unless otherwise provided by applicable double tax treaty. In order to be able to utilize beneficiary withholding tax rates, payer of interest needs to possess certificate of residence of the income receiver, validated from the competent tax authorities.

On the other hand, it is not clear whether withholding tax on interests should be applied and who should be liable to withheld taxes on interest if synthetic transfer takes place. Legal rights on receivables still remain at the bank, but the economic owner would be a foreign entity.

It is our opinion that in this scenario the substance over form principle should be applied, meaning that withholding tax on interest income would be due for payment. In our view, the Bank as the payer of income to foreign entity should withhold and pay tax.

⁶ NBS's Decision on Reporting on Foreign Credit Transactions (*Odluka o izveštavanju o kreditnim poslovima sa inostranstvom*) and NBS's Guideline for Completing Forms for Reporting on Foreign Credit Transactions (*Uputstvo o popunjavanju obrazaca za izveštavanje o kreditnim poslovima sa inostranstvom*).

Our opinion is based on the fact that in some cases of synthetic transfer debtor might not even be notified on the arrangement between the bank and the buyer, and therefore certainly not aware of the obligation to calculate and pay withholding tax.

Tax treatment of loans does not differ with respect to currency in which the loan is denominated in. All comments presented in this report are fully applicable to receivables from loans denominated in any currency.

4.3.3 Solutions & recommendations

High priority recommendations:

- i. **Prohibition of loan transfers to foreign entities** - Very strict F/X Act (incomparable to any neighboring or developed European jurisdictions) and practice of the regulators in applying it should be significantly relaxed. Namely, the F/X Act should explicitly allow off-shore sale of NPLs so that banks may transfer their receivables against resident – legal entities that are based on domestic credit arrangement to NPL's acquirers / AMCs established and operating abroad. Alternatively, such exemption might at least pertain to AMCs incorporated in the EU and OECD member countries. Further, it should not restrict contractual freedom of the parties by prescribing mandatory elements of the cross-border loans and by imposing a requirement that a resident borrower acknowledges and executes NPLs sale. Residents should be able to grant security for the benefit of off-shore AMCs;*
- ii. **Necessity of formal registration of loans & changes** - The F/X Act and by-laws adopted by the NBS should be reformed in a way that registration of a particular loan or any change thereto with the NBS is not a condition for its validity and operability. It is acknowledged that the NBS has a valid interest to monitor foreign exchange inflow and outflow for statistical and policy purposes; however, such macroeconomic role of the NBS should not result in NBS's review and micromanagement of every cross-border transaction and its further changes (e.g. changes of parties). Instead of rubber-stamping each cross-border transaction and its further changes, the rule should be that Serbian residents are only notifying (e.g. quarterly) the NBS of its cross-border transactions. Also, hidden obstacles such are specific codes (šifrarnik) provided for in by-laws and guidelines issued by the NBS should be removed;*
- iii. **Necessity of borrowers' consent to a change of lender in particular cases** - Providing in the F/X Act that NPL's acquirers which are not banks are entitled to acquire from banks receivables based on all credit arrangements which banks are entitled to enter into (including retail performing and non-performing portfolios), regardless of whether resident – legal entities are entitled to enter into such credit arrangements and that once an the acquirer acquires such receivables it has all rights that a bank would have in connection*

with such receivables, including right to security interest securing such receivables.

- iv. Restricting entities in Serbia to provide cross border guarantees only to their foreign subsidiaries** - Residents should be able to grant security for the benefit of foreign AMCs without requirement that foreign debtors are majority owned subsidiaries of Serbian residents.

4.4 Tax related aspects of a NPL sales transaction

4.4.1 Tax perspective

The Serbian tax legislation apart from the specific provision on the sale of receivables in Law on Corporate Income Tax (article 16a) and recently introduced changes in VAT Law (in relation to application of reverse charge mechanism in case of enforced sales i.e. registered VAT buyer is obliged to assess VAT and deduct it as input VAT if general conditions for input VAT deduction are met), contains no other specific provision related to the sale of NPL.

VAT treatment of sales of receivables

In accordance with the Law on VAT, for the bank the transfer of receivables is exempt from VAT without the right to recover input VAT.

As already explained above the outright sale of receivables is adequately regulated from the CIT point of view. Any losses arising from the difference between sale price and net book value of receivables would be recognized as deductible. From a VAT perspective, the transfer at bank level would be deemed as VAT exempt without right to deduct input VAT supply.

From a VAT point of view, in substance, the bank transfers the portfolio of non-performing loans with related risks (e.g. of the debtor's default) and future benefits (i.e. future related cash-flows). The fact that formally the legal title over receivables is not going to be transferred and that the bank will be involved in the administration and forced collection procedure should have no impact on the substance of the transaction.

From VAT point of view, the main question is if the above mentioned transfer is within the scope of Serbian VAT and if the exemption from the article can be applied.

While, based on the substance of the transaction, it can be concluded that exemption should be applied, such an approach is not without a risk. Strict interpretation of the legal framework can lead to conclusion that the bank actually assigns certain rights (in a form of, amongst other, future cash-flow) against consideration and should charge VAT.

Additionally, in our understanding, the bank may continue to perform activities in relation to collection of the receivables and remains in charge for all legal procedures related to enforced collection. It could be argued that these activities should not be viewed as separate supply but rather as ancillary activity to the main activity (transfer of receivables) and, thus, not subject to VAT. Namely, according to the practice in European Union, in case where there is no separate fee for work out service, a work out service would be deemed ancillary to the main supply as it does not present an end in itself, but is intended in better enjoying the main supply for the buyer. In our view, the bank will not conduct enforced collection of receivables in order to profit from collection activities, but to support the sale of receivables.

If the transferee would perform the collection procedures, it is our opinion that there is a risk that the Tax Authorities consider that transferee provides those services to the bank without consideration, arguing its interpretation by retention of legal rights at the banks. Provision of services without consideration is considered a VATable supply, so output VAT could be charged to the transferee in that case.

CIT treatment of sale of receivables

Sale of NPLs is regulated from the CIT perspective by the article 16a of the CIT law. According to the stated article, losses generated from the sale of receivables are fully recognized for tax purposes.

Article 16a of the CIT Law was introduced in May 2013. Previously, the Ministry of Finance (MoF) issued several opinions where tax treatment of loss from the sale of receivables was equalized with tax treatment of write-off of receivables. Please note that MoF in the opinion number 413 - 00 - 11155/2011 - 04(II) dated 14 May 2012 dealt with the synthetic sale of receivables (transfer of risks and rewards in relation to receivables where legal title over receivables is not transferred). This opinion also states that the loss from the transfer of sale of receivables is recognized for tax purposes only if conditions for recognition of write-off expenses for tax purposes are recognized.

4.4.2 Other tax considerations

Investment in distressed entities

There is no special tax implications regarding investing in distressed entities. There are no tax incentives or impediments to investments.

In accordance with the applicable legislation, any monetary investment should be tax neutral from the tax perspective. Exceptionally, debt-to-equity swap would trigger withholding tax liability for the amount of interest converted into capital, if the lender/new investor is a foreign entity and there is no Double Tax Treaty protection.

Additionally, non-pecuniary investment may be treated as VATable supply of goods or services if investment does not fulfill conditions of VAT Law to be considered as transfer of a going concern

(article 6 of VAT Law). If investor is a registered VAT payer and supply of invested goods or services is not VAT exempt, investor will be obliged to calculate and pay VAT on the goods invested into capital. Also, for the purpose of future adequate assessment of capital gain on the sale of shares/ stakes received in return for assets contributed in kind, an evaluation by authorized appraiser needs to be done in order to determine market price of assets contributed/ stakes/shares issued.

Any financing by related party debt will be subject to thin-capitalization and transfer pricing tests. Withholding tax of 20% is payable on payment of interests abroad, unless otherwise provided by applicable double tax treaty.

Other CIT issues

An attention should be drawn to the following CIT issues that regularly occur in practice and which have been reported by potential investors as impediments to NPL market development:

- Tax treatment of losses resulting from measuring assets at fair value through profit and loss
- Tax treatment of long term provisions for court cases

Treatment of fair value losses

As previously explained acquired NPL portfolio is initially measured at fair value. It is common that the purchase price paid for NPL is equal to fair value of NPL at the time of acquisition.

Making provisions for loans at initial recognition is not appropriate. Impairment provision is calculated and recorded only after identification of objective evidence of impairment, which normally occurs after the initial recognition.

During the initial recognition, loans are classified into one of the categories of financial instruments, as defined by the requirements of IAS 39. Classification is based on the conditions existing at the date of purchase. Initial classification directly determines subsequent measurement of assets in the financial statements. Loans are usually classified as loans and receivables, but could be classified as financial assets measured at fair value through profit and loss or financial assets available for sale.

Receivables is the most common category for initial classification of purchased NPLs. Purchased receivables are subsequently measured at amortized cost. Acquired receivables would have new effective interest rate which will be calculated as an internal rate of return, a rate that exactly discounts estimated future cash flows of the receivable to its fair value – acquisition price. Interest income the entity recognizes in subsequent years is assessed by using the effective interest rate, unless changes in expected cash flows occur.

In the case of financial assets carried at fair value, change in fair value is recognized through the income statement.

Some investors, although not common, will opt for subsequent measurement of acquired receivables portfolio at fair value through profit and loss.

CIT law prescribes no special rules for income/ expenses resulting from fair value measurement of assets and liability. Therefore, according to general CIT provisions any income or loss from fair value measurement would be considered taxable/ deductible.

On the other hand, the article 22v of the CIT Law states that expenses related to impairment of assets are not tax deductible when incurred. The CIT Law provides definition of impairment of assets as the difference between net book value of an asset determined in accordance with IAS and IFRS and its estimated recoverable amount. The CIT Law provides for deductibility of these expenses in the period during which impaired assets are sold or used.

From accounting point of view, impairment expenses and losses arising from fair value measurement of assets have completely different nature. Impairment expenses are determined by application of (amortized) cost/ revaluation model of measurement and only when objective evidences of impairment are identified, while fair value losses arise from application of fair value measurement concept regularly occur as normal result of applying the fair value measuring technic. However, due to the wording of the CIT Law, in the previous period, the MoF issued non-binding opinions stating that fair value losses should be treated as impairment and consequently considered tax non-deductible expenses in the year they occur.

However, recently MoF issued a binding opinion number 011-00-00088/2015-04 dated 16 July 2015 where the MoF stated that fair value losses (losses resulting from application of fair value measurement concept) are considered tax deductible in the period when such losses are recognized.

The latest available interpretation of the MoF is acceptable and the additional clarification should be provided in Rulebook on Tax balance sheet to clarify that losses from applying the accounting concept of fair value measurement through profit and loss are recognized for tax purposes notwithstanding the nature of assets measured (investment property, financial instruments, livestock, etc.). Also it is our opinion that previously issued opinions of MoF stating that fair value losses are not recognized for tax purposes in the period they occur should be canceled. Moreover, in future particular attention should be devoted to achieving uniform interpretation of the article 22v amongst representatives of the tax authorities.

Long term provisions for court cases

Furthermore, article 22b of the CIT legislation prescribes that the following long provisions are treated tax deductible: long term provisions for renewal of natural resources, warranty period costs, retained caution money and deposits as well as other long term provisions recognized in accordance with legislation. Long-term provisions for issued guarantees are recognized on a cash basis.

Provisions made for potential losses in court cases are not recognized for CIT purposes in tax period when those provisions are recognized. CIT Law prescribes exemption from tax for revenues from cancellation of long term provisions which were not tax deductible. Consequently, in case the court case is lost and provisions are cancelled due to outflow of money but no income is recognized as there is no economic reason for recognition of income (on the contrary the outflow of money confirms that the initial management estimate was adequate) expenses related to provisions for court cases are permanently nondeductible. As a result, many entities refrained from making adequate provisions.

4.4.3 Solutions & recommendations

High priority recommendations:

- i. **Lack of specific recognition of synthetic transfers by VAT and CIT Laws** – *Relevant bylaws of the Law on VAT should be modified to clarify that VAT exemption is applicable to both synthetic and outright sale of receivables. From a CIT perspective it would be appropriate to clarify in CIT Law or the Rulebook on Tax balance sheet in a manner that the transfer of rewards and risks in relation to NPL should be treated as the sale of receivables. Synthetic transfer of receivables where the bank derecognized NPL portfolio, should be also defined as VAT exempt without right to recover input VAT supply by VAT Law or the relevant VAT Rulebook.*

VAT Rulebook should be also changed in order to include explanation that collection activities performed by the buyer of receivables who acquired risks and rewards on receivables via synthetic transfer do not represent free of charge services provided to transferor, notwithstanding the fact that the transferor retained legal rights over receivables.

4.5 Accounting aspects

The following paragraphs reflect on the accounting perspective of NPL transactions taking into consideration the current legislation and regulatory framework, i.e. IFRS.

4.5.1 Impairment provisioning

In accordance with the Law on accounting as well as banking regulations in Serbia, banks are required to prepare financial statements in accordance with IFRS, thus regulating loans, more particularly provisioning performed in accordance IAS 39.

The following are some facts about loan loss provisioning, that banks perform performed in accordance with IAS 39:

- IAS 39 involved an incurred loss approach with the right motive, i.e. to limit management's possibility to affect P&L manipulation throughout creating hidden reserves. However, fixing one

problem – reducing the space for profit manipulation created another one – recognizing impairment provisioning losses in P&L too late.

- IAS 39 is principle based standard which leaves plenty of space for professional judgment and misapplication which ultimately can easily result in low levels of provisioning
- Some definitions in IAS 39 such as objective evidence of impairment, or estimated future cash flows are too vaguely defined again leaving plenty of space for interpretation and provisioning manipulation
- IAS 39 practically requires the occurrence of objective evidence of impairment, i.e. loss event. In case this is not identified, the asset is assessed on a group level with those of similar credit risk. This approach also very much varies across the banking sector in Serbia making significant differences among provisioning levels at different banks in pretty similar and homogenous groups of assets exposed to similar credit risk.
- Provisioning as defined by IAS 39, determined by discounted cash flow approach using initial contractual effective interest rate leads to net asset value that often significantly differs from fair value. In a fact these are two – completely different concepts.

Because of all identified shortages of IAS 39, since November 2008, the IASB has been working to replace its standard on financial instruments. After long work on the standard, cooperation with Basel Committee for Banking Supervision, IASB has issued final version of IFRS 9 Financial instruments as at 24 July 2014.

Due to the criticisms of the incurred loss model as defined by IAS 39, IFRS 9 introduces an expected loss model.

The more forward-looking expected loss model introduced by IFRS 9 should help investors and other stakeholders get a better picture of the risks banks face with regard to potential losses on loans and other financial instruments.

New impairment model requires banks to recognize, at a minimum, 12-month expected losses on all loans and full lifetime losses on loans that have experienced a significant increase in credit risk.

According to Hans Hoogervorst, IASB chairman: “First indications are that this model will lead to a very substantial increase in the level of provisioning, in the order of around 35 per cent” (ICAEW-IFRS Foundation conference, London, UK, 15 September 2015).

However, there is significant amount of time since IFRS 9 effective date defined at 1 January 2018 and in our view NBS should force banks to start preparing for the new standard on time.

4.5.2 Derecognition criteria

It is necessary to understand the concept as prescribed by IAS 39 – Financial Instruments: Recognition and Measurement which regulates accounting treatment of financial assets.

In accordance with IAS 39, an instrument is recognized in the statement of financial position when the entity becomes party to a contract that is a financial instrument. Accordingly, if a transfer of a financial asset does not qualify for derecognition, then the transferee does not recognize the transferred asset as its asset in its statement of financial position, but derecognizes the cash or other consideration paid and recognizes a receivable from the transferor.

Therefore, the key question is the one that concerns – under which circumstances a certain financial asset, in this particular case an NPL, should be derecognized in the Bank's books and subsequently recognized in the purchaser books. The decision of recognition of the receivable will then affect who is actually the counterparty in the contract, including the assessment of impairment in subsequent measurement.

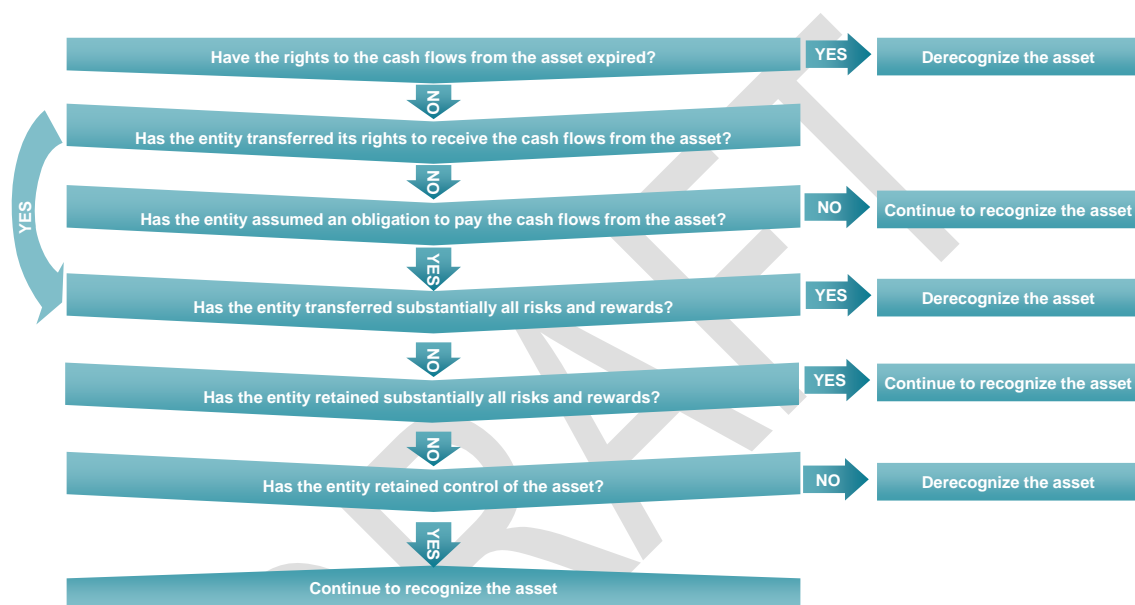
The Bank needs to adopt a step by step analysis of the contractual terms and risk and rewards to determine whether or not derecognition of receivables is appropriate. Legal form of contracts and achievement of legal sale / transfer is not adequate in itself to result in derecognition for accounting purposes.

Paragraphs 17-20 in IAS 39 specify conditions under which certain receivables can be derecognized in one's books, and accordingly recognized in the books of the counterparty.

In accordance with these paragraphs, there are three key questions that need to be assessed when a specific receivable is assessed on the basis of whether it should be derecognized (i.e. recognized in the books of the receivables purchaser):

- Have the contractual rights to the cash flows from the financial asset expired?
- Have the contractual rights to receive cash flows been transferred? and
- Whether risk and rewards relating to the specific receivable have been transferred to the purchaser?

Furthermore, IAS 39 has provided a detailed flowchart that summarizes all requirements for evaluation of whether and to what extent a certain financial asset should be recognized:



However, apart from all of the aforementioned and elaborated, it is not always easy to assess and decide on whether a certain financial instrument should be derecognized. Therefore, each and every specific transaction should be analysed individually.

Accounting treatment is further elaborated in details in Appendix 2.

4.5.3 Solutions & recommendations

High priority recommendations:

- i. **Strict derecognition criteria as prescribed by the IFRS** - The key accounting issue in the NPL transaction is whether all requirements as defined by IAS 39 have been met in order to have loan/portfolio derecognition fulfilled. This mostly focuses on the issue of risk and rewards transfer and not depending on the legal aspect of the transaction. With respect to IFRS, all transactions should be subjected to an analysis on a case by case basis, whether all requirements have been met.

Legal obligations, such as notification to the NBS, SPA signing etc., should not determine the timing of derecognition but rather transfer of substantially all risk and rewards linked with NPLs from seller to buyer, in line with IFRS criteria

Other recommendations:

Being aware of the issues caused by inadequate provisioning by the financial institutions in the past, and the shortages of the incurred loss model, International regulatory bodies have been working on replacement of IAS 39 with new standard on financial instruments, IFRS 9, which will be effective on 1 January 2018. Main difference will be movement of focus in some cases on lifetime credit loss (comparing to current 1-year horizon), which will, as estimated, affect the significant increase of provisioning level overall in the banking sector.

NBS should force banks to start preparing for IFRS 9 adoption in a timely manner.

5 Post sales

5.1 Transfer of collaterals

5.1.1 Legal perspective

The following paragraphs reflect on the issues related to the transfer of mortgages, share pledges and property ownership in connection with the sale of NPLs, including questions connected with public registries.

Currently, most important acts that govern rights relating to property are the Obligations Act, Secured Transactions Act and the Mortgage Act. These acts address the issues relating to transfers of property rights in the following:

- **Article 437 Paragraph 1 of the Obligations Act** - With assignment of claims accessory right such as, payment priority, mortgage, pledge, surety rights, interest, contractual penalty are transferred to assignee. Nevertheless, in relation to non-possessory pledge and mortgage, the registration of a new secured creditor (assignee) with the asset title registers is still necessary. On the other hand, re-registration of possessory pledge, bills of exchange, sureties and guarantees (unless they are cross-border) is not necessary;
- **Article 4 Paragraph 1 of the Secured Transactions Act** – Pledgee acquires the right to pledge by registration in the Pledge Registry (i.e. both attachment and perfection of pledge is achieved through registration with the Pledge Registry);
- **Article 8 Paragraph 1 of the Mortgage Act** – Mortgage is constituted by registration in competent Real Estate Cadaster (i.e. both attachment and perfection of pledge is achieved through registration with the Real Estate Cadaster).

With regards to the above explained, the following impediments to NPL market development exist:

- **Establishment of security interest** - While the re-registration of the non-possessory pledge over movable assets/intangibles is a routine and quick procedure before the Pledge Registry, re-registration of real property mortgages is typically much more time-consuming due to the inefficiency of the Real Estate Cadasters in Serbia.
- **Second instance administrative procedures.** The main bottleneck in preserving the security interest is second instance administrative procedure, i.e. procedure initiated upon appeal of an interested party (e.g. underlying debtor) to the re-registration of the new secured creditor (acquirer of the NPL). Due to significant understaffing of the competent Ministries (as second instance authorities), the finality of the re-registration might last for several years which will severely deter potential investors from secured NPLs portfolios and/or influence their price;

Priority and hardening period. Any amendments to the security agreement which would alter essential elements (*bitne elemente*) of the pledge / mortgage would affect priority/ranking of such pledge / mortgage i.e. it would be considered as a new pledge / mortgage and therefore would have the priority as of the day of inscription of such alteration in the Pledge Registry / the Real Estate Cadaster (and thus different hardening period), ranking lower than pledges / mortgages registered before the alteration. There is no consistency in the practice as to which elements of the pledge / mortgage should be considered as essential elements. Hence, change of the secured party in the Pledge Registry / the Real Estate Cadaster may result in loss of priority and reset of the hardening period for claw-back of the security interest by insolvency administrator or aggravated creditors of the underlying debtor.

5.1.2 Solutions and recommendations

High priority recommendations:

- i. **Inefficiency of mortgage re-registration** – Having in mind that the underlying debtor (borrower) may frustrate the re-registration process by lodging an appeal (even frivolous) before a second instance court against such re-registration, the appeal by itself should not suspend the re-registration and perfection of the security interest for the benefit of the acquirer. In this manner certainty for the acquirer of NPL on the enforceability of the collateral attached to the NPL would be improved.*
- ii. **Insufficient capacity of the second instance authorities** - Improvement of capacities of the Real Estate Cadasters and second instance authorities – Significant improvement of the authorities' capacities to process pending re-registration requests or appeals in a reasonable time frame is crucial for facilitating market of mortgage backed NPLs. In the meantime, the authorities (especially the NBS) should be flexible and supportive of the synthetic transfer arrangements (discussed above under section 4.1 given that such arrangements do not involve registration of a new creditor with the competent registries;*
- iii. **Influence of pledge/mortgage change on the rank/priority** - Safeguarding priority and original hardening period commencement. The Secured Transactions Act and the Mortgage Act should explicitly provide that change of the secured creditor in the Pledge Registry / the Real Estate Cadaster shall not cause loss of initially established priority of the respective security interest not it shall be considered as a new security interest which is subject to new hardening periods in case of distress / insolvency of the underlying debtor.*

5.2 Fresh money injection

Current Serbian rules do not prohibit investors to inject fresh new capital (loan/equity) into troubled companies (assuming that the new investment is not a fraudulent conveyance transaction (pobijanje

dužnikovih pravnih radnji) within the meaning of the Obligations Act or voidable preference transaction (pobijanje pravnih radnji stečajnog dužnika) within the meaning of the Insolvency Act).

However, such investors are not awarded with statutory super-seniority either, except in the case of insolvency procedure opened against the distressed company. Namely, if insolvency proceedings have been opened, the insolvency administrator may, with the approval of the creditors' committee and the insolvency judge, enter into loan agreements and related security agreements on behalf of the company in order to keep the company operating (Article 27 Paragraphs 2 and 3 and Article 28 of the Insolvency Act). Such loans are treated as liabilities of the insolvency estate (*obaveza stečajne mase*) and, pursuant to Article 54 Paragraph 1 of the Insolvency Act, enjoy priority in the distribution of insolvency proceeds, ranking ahead of employment and tax liabilities and other unsecured creditors (new money priority).

The Insolvency Act in Article 157 does provide that one of the UPPR measures may be conclusion of a credit or a loan agreement. Irrespective of this existing possibility, so far there are no notable UPPRs over larger companies that have been fully and successfully implemented in Serbia. The key reason for failure of most UPPRs is lack of funding i.e. fresh money to keep the company going concern and able to effectively implement the UPPR measures.

The Insolvency Act already identifies conclusion of a credit or a loan agreement (zaključivanje ugovora o kreditu, odnosno zajmu) by a company undergoing an UPPR procedure as a measure that may be envisaged by the respective UPPR. However, the Insolvency Act does not clearly state that a provider of such credit or loan will enjoy super-seniority i.e. that it will be repaid ahead of other existing creditors.

5.2.1 Solutions and recommendations

High priority recommendations:

- i. **Lack of guarantees for super-seniority of new money under UPPRs / judicial insolvency reorganization** - Given that the lack of new money is a key reason for failure of most UPPRs, the providers of such fresh money should be incentivized to do so by way awarding them with super-seniority over the existing creditors.*

Article 157 of the Insolvency Act may be amended in order to clearly enable that if certain per cent of existing creditors agree (e.g. creditors holding certain 2/3 of the total amount of claims), the provider of new money will enjoy super-seniority and rank ahead of all other creditors Including existing secured creditors.

- ii. **New money under UPPR not qualifying as a liability in the insolvency** - It should be also specifically clarified in the Insolvency Act that, in case of failure of the UPPR, this super-seniority should be retained by way of qualifying it as liability of the insolvency estate*

(obaveza stečajne mase). If this would not be the case, possible providers of fresh money will be very reluctant to inject such new money into a distressed company and thereby possibly recuse it;

5.3 Related party issues and value leakage

5.3.1.1 Introduction

The systematic use of related party transactions and the deterioration of value for the creditors has to be seen in connection with the practice in Serbia of blocking accounts in case of debtor difficulties.

In many cases in practice, Bills of Exchange (including connection with authorization to use it) were used as an instrument by creditors, secured and unsecured, to enforce the blockade of a debtor's account. Bills of Exchange are usually requested by creditors, i.e. suppliers and banks alike, to secure the access to the debtors account in case of financial difficulties. In case of the latter, the Bills of Exchange together with the authorization to use would be utilized to block the account, meaning, the creditor enforces collection through the account of the borrower through the central account register of the National Bank in Kragujevac. Any other form of credit would require court ruling in favour of the creditor before enforcing.

The issue in practice is that the account blockade does not recognize the creditors according to their rank, but by the sheer order of enforced BoEs and order of request to block the account. This is clearly to the advantage of small and uncollateralized creditors. However, the main problem occurs through the cash sweep, as all available funds on the accounts of the borrowers are used to settle the claims from the BoEs. Consequently, in case of a financial distress, a company loses not only control over its bank accounts, but is also deprived from any liquidity which must already have been tight before.

An additional problem in practice is actually the lifting of the blockade. While theoretically a standstill among the creditors could lift the blockade, this has only been achieved in very cases as there is no trust among creditors (adhering to agreements), not only among suppliers and banks, but also among banks. The standstill would determine the order of the initial blocking and stipulate that this order would be re-installed if the standstill expires, which however, is not an automatic action, but requires each creditor to place the blockade in the same order.

In case the blockade continues, it could be lifted through the UPPR or in case of insolvency, however, in both cases, the borrower in financial distress has become a defaulted borrower and another NPL.

As a consequence of losing control over its bank accounts and being left without any liquidity to run the business, owners and management of companies see themselves forced to act in a 'grey zone' to keep the business alive and to have some form of related party transactions. In many cases, a dormant company or subsidiary, SPV or the company of a related person is used to continue the business as these accounts are not blocked. These companies usually use the assets of the blocked

company to produce and also acquire the receivables to have access to funds (through collection). In many cases, disadvantageous loans have to be taken in order to have Working Capital.. While operations may be kept alive for some time, this set-up is extremely costly and leads to loss of clients and suppliers which ultimately accelerates the bankruptcy of the company and the new vehicle.

Although clearly linked to the original business, the new and the old company are not seen as a related party by the authorities, neither by tax authorities nor by the NBS. However, Banks make collections from these "new" businesses to reduce the exposure to defaulted counterparty in blockade.

Overall, the practice of blocking accounts fails to serve its purpose as it aggravates the financial distress and actually led to an increase in insolvencies as it has been misused to achieve a repayment through cash drain rather than to initiate a restructuring. Serbia seems to have established a distinct disadvantageous mechanism of BoEs and blocking of accounts and also its misuse.

Related party transactions are a mere form of survival for distressed companies as the blocking of accounts does not allow any maneuvering space and deprives also of any cash left in the companies. A deterioration of value takes place through these actions, however, the practice of related party transaction is in practice only rarely prosecuted. Any criminal action in this connection should be prosecuted by law.

5.3.1.2 Counterproductive effects of centralized state supported cash sweep system

According to the current (and previous) Payment Services Act (Zakon o platnim uslugama) (Official Gazette of RoS, no. 139/2014) and NBS's Decision on the Manner of Enforcement of Claims by Debiting the Client's Account (Odluka o načinu vršenja prinudne naplate s računa klijenta) (Official Gazette of RoS, no. 14/2014), the NBS (i.e. its Division for Receipt, Control and Entry of Execution Titles and Orders, Kragujevac) is obliged and authorized to perform enforced collection of claims by debiting any of the debtor's accounts (dinar or foreign currency accounts), without the holder's consent, based on enforceable orders (from tax, customs, court or other authorities), and payment orders (with regard to securities, bills of exchange and authorizations), in line with the prescribed order of priorities and the time of receipt within the same priority group. Practically, this state supported centralized cash sweep mechanism causes blockage of all bank accounts held by the debtor and prohibits banks from opening new accounts to such debtors. Such blockage of bank accounts deprives a debtor from any control over its cash flows, impairs flexibility to negotiate a workout solution with directly affected creditors, destroys company's value and inevitably leads it into the insolvency/UPPR although a consensual out of court workout might have been possible.

5.3.1.3 Criminal law protections - international examples

The international practice and literature has generalized the following most common insolvency fraud schemes as: (i) the "bustout" where a company has no intention of paying its debts and starts selling its assets below the market price or conceals them in a related company, which leaves no assets for

satisfying its creditors' claims; (ii) the "bleedout" which is achieved by depleting company's assets usually over a long period of time, through highly complicated transactions, which involve related party / insider transactions and (iii) "looting" where a company or its owner did not conduct business activities in a fraudulent manner until it was faced with the forthcoming bankruptcy; looting may occur during the negotiations over the potential workout, but also within the bankruptcy proceedings.

These fraudulent schemes have been treated as criminal offences in various jurisdictions, most notably in the US under Title 18 of the United States Code which regulates crimes and criminal procedure and its chapter 9 (often referred to as the US Bankruptcy Criminal Code).

5.3.1.4 Criminal law protections - Serbian rules

Apart from not specifically and thoroughly recognizing all the above fraudulent schemes as criminal acts, in the Serbian practice, even the existing criminal acts are not strictly enforced. Currently, the following criminal acts exist in the Serbian legal system and they should be enforced in a stricter manner as a measure of general and special prevention of fraudulent schemes which heavily undermine goals of insolvency legislation:

- Article 582 of the Companies Act: Entering into a transaction or taking of an action if personal interest is involved (Zaključenje pravnog posla ili preduzimanje radnje u slučaju postojanja ličnog interesa).
- Article 237 of the Serbian Criminal Code (Krivični zakonik) (Official Gazette of RoS, nos. 85/2005, 88/2005, 107/2005, 72/2009, 111/2009, 121/2012, 104/2013, 108/2014) ("Criminal Code"): Deceive of creditors (Oštećenje poverioca).
- Article 235 of the Criminal Code: Causing insolvency (Prouzrokovanje stečaja).
- Article 236 of the Criminal Code: Causing false insolvency (Prouzrokovanje lažnog stečaja).
- Article 208 of the Criminal Code: Fraud (Prevara).
- Article 209 of the Criminal Code: Unsubstantiated use of loans and other privileges (Neosnovano dobijanje i korišćenje kredita i druge pogodnosti).
- Article 204 of the Insolvency Act: Filing of false claims (Prijavljivanje lažnog potraživanja).
- Article 205 of the Insolvency Act: Disposal of debtor's assets after the opening of bankruptcy proceedings (Raspolaganje imovinom stečajnog dužnika posle otvaranja stečajnog postupka).
- Article 206 of the Insolvency Act: Misrepresentation and concealment of facts in a UPPR (Lažno prikazivanje i prikriivanje činjenica u unapred pripremljenom planu reorganizacije).

5.3.2 Solutions and recommendations

High priority recommendations:

- i. **Systematic use of related party transactions and the deterioration of value for the creditors in large complex NPL cases** – Abandoning the centralized cash sweep mechanism by the NBS should be considered. Such mechanism is not widely recognized in comparative practice and although it has proven to be an efficient debt collection system in Serbia, its overall effects are more negative than positive.*

Other recommendations:

As regards value leakage issues and misconducts in connection to related party transactions during insolvency, relevant criminal acts are recognized by the Serbian legal system, however they should be enforced in a stricter manner as a measure of general and special prevention of fraudulent schemes.

5.4 Group/Consolidated UPPRs

The Insolvency Act regulates reorganization / UPPR of a debtor as an individual company and not as a part of the corporate group. Therefore, for the reorganization / UPPR of each member of the corporate group, a separate case file is assigned, and if respective group members are seated in different places, separate local courts will be competent and separate insolvency judges will be appointed.

Conducting several parallel reorganizations / UPPRs, some of them before different competent courts and with a different insolvency judges is a significant logistical, cost and timing burden. It increases legal uncertainty and makes reorganization / UPPR process considerably less effective in most of the cases.

5.4.1 Solutions and recommendations

High priority recommendations:

- i. **Regulating UPPR of a debtor as an individual company and not as a part of the corporate group by the Insolvency Act** - It should be considered that the Serbian Insolvency Act is amended in order to explicitly regulate and permit the joint pre-pack restructuring plan (*jedinstveni unapred pripremljeni plan reorganizacije*) which will enable that reorganization of an entire corporate group is carried out within single procedure and within the same court and before one insolvency judge. This joint UPPR does not disregard separate legal personalities of each group member companies because creditors of each company would have separate voting rights (i.e. creditors of one group company should not be diluted by creditors of another company from the group); however, it enables that the UPPR is carried out with in the same procedure and that the end result is one single UPPR instead of several converging UPPRs.*

5.5 Adoption of a reorganization plan / Cram-down

5.5.1.1 Rules and impediments

For the purpose of voting on a reorganization plan / UPPR, creditors are ranked into classes pursuant to mandatory insolvency lines. The Insolvency Act allows flexibility to create additional classes of creditors and the insolvency judge may approve or (even) order such additional classes.

A reorganization plan / UPPR is approved if each creditor class votes in favor of its adoption; a creditor class approves the plan by a favorable vote of its members who hold more than 50% (simple majority) of the amount of claims in that class. If just one creditor class does not approve the reorganization plan / UPPR, the plan / UPPR will not be adopted.

If the reorganization plan / UPPR is adopted by all creditor classes and approved by the court, it will bind dissenting members within the class.

Although cramming down within classes is possible, a reorganization plan / UPPR cannot cram-down entire classes of creditors who did not approve the plan.

This means that only one class of dissenting creditors can prevent adoption of the reorganization plan / UPPR, even if all other classes and creditors have supported the reorganization plan / UPPR.

5.5.1.2 Enforceability of debt to equity swaps

The Insolvency Act in Article 157 contains a non-exhaustive list of measures that may be implemented by the debtor within the UPPR. One of the measures is conversion of creditor's claims into the equity of the debtor.

Given that debt to equity swaps effectively dilute the existing shareholders, the Companies Act envisages that their consent is required for the debt to equity swap (in the form of a shareholders' meeting resolution on approval of share capital increase by way of debt to equity swap).

5.5.2 Tax related issues

Tax treatment of share-based payments

In our view, tax treatment of share-based payments could affect investor decisions and increase their reluctance to take over distressed entities. In our view, many investors would in course of restructuring distressed entities consider granting shares of either distressed or investing entity to the top management. Considering that tax treatment of share-based payments in Serbia is highly unclear, amendments to the PIT Law in this respect could accelerate the development of the NPL market.

Namely, in our view, personal income tax legislation unclearly defines situations where shares of investing entity are granted to managers of distressed entity (employed with distressed entity). Namely, doubt arise about the following:

- Who should bear the burden of report and calculate salary tax.
- When the taxable event occurs.
- What is the tax and SSC base?

Namely, burden of calculating and reporting salary tax is levied on the payer of the income. If the payer is registered abroad, employee is obliged to self-assess and report salary tax. In our opinion, the payer of income in analyzed case would be considered related party granting shares.

However, in accordance with the PIT Law, shares granted to employees by the employer's related party are considered salary at the moment employees obtain disposal rights, except if the costs of granted shares is borne by the employer. In that case, share grant is considered salary at the moment when employer posts costs of granted shares in its financial statements. In our opinion, associating the occurrence of taxable event with postings in employers accounting system could result in an interpretation that if the employer recognizes the cost that in substance the employer is considered the payer of income.

It is our opinion that the intention of legislator when introducing the above provision was to levy obligation of calculating salary tax and SSC on the employer in those situations in which cash settlement occurs, in accordance with the IFRS 2, i.e. when a related company invoices the employer for shares granted to employees. However, strict interpretation of the stated provisions leads to conclusion that employer, which applies IFRS 2, will bear costs of granted shares in any case, by simple recognition of salary expenses, and that it might be considered payer of income anyway. The MoF recently issued an Opinion stating that tax is due only once employee obtains disposal right of shares.

5.5.3 Solutions and recommendations

High priority recommendations:

- i. **Possibility of one class of dissenting creditors (irrespective of its size) to prevent adoption of the reorganization plan / UPPR** - All developed jurisdictions have devised specific forms of reorganization arrangements aimed to enable all stakeholders to agree on and carry out a plan which (i) facilitates higher level of recovery for the creditors, while at the same time, (ii) rescues their debtor from liquidation. The ultimate goal is to preserve value, businesses and jobs, to the extent possible. Generally, the same goal could be achieved within an out-of-court workout between a debtor and its creditors. Still, any informal work-out is faced with the so called "holdout issue", i.e. requirement that all creditors unanimously support the worked out arrangement / restructuring agreement. Although a workout solution would be better for all creditors and the debtor, the holdout dissenting creditor can force from other creditors a preferential treatment by threatening to undermine the work-out by withholding its support.

Modern insolvency legislation have responded to the holdout issue by allowing the debtor and the creditors to agree on and adopt a formal court-backed reorganization plan which is binding even if certain creditors are against it. The Serbian Insolvency Act also provided for this possibility.

However, the Serbian Insolvency Act did not entirely solve the holdout issue, given that just one class of creditors (even if it holds less significant amount of claims against the debtor), can ruin the entire plan and cause liquidation of a debtor and its assets. This is not in line with best international practice e.g. most notably Chapter 11 of the United States Bankruptcy Code, which, pursuant to its sections 1121 through 1129, provides that, under certain conditions "if a class votes against the plan, the plan still might be confirmed under the cram down rules" .

It should be considered that the Serbian Insolvency Act is amended in order to enable that a reorganization plan / UPPR may be adopted even if one or more classes are against it, provided that:

- creditors holding certain 2/3 of the total amount of claims have voted in favor of the reorganization plan / UPPR, irrespective of their division within separate classes; and
- a dissenting class of creditors may not be unfairly impaired i.e. compelled to accept less than it would receive in a straightforward bankruptcy, according to the liquidation value appraisal report (procena novčanog iznosa koji bi se dobio unovčenjem imovine sprovedenjem bankrotstva). The appraisal of the value of the assets which can be obtained from sale of assets in the insolvency procedure already has to be made and included in the UPPR pursuant to existing Article 156 paragraph 1 item 13 of the Insolvency Act.

For example, the similar reform has been recently announced in Italy as a measure that should facilitate easier NPL resolution (the new Article 182 of the Italian Bankruptcy Law introduced by law Decree No. 83/2015).

- ii. **Lack of technical and human capacity and experience of courts dealing with insolvency/UPPR cases** - For the purpose of more efficient implementation of insolvency rules, it should be considered that special departments within commercial courts are designated specifically for insolvency/UPPR cases. Judges working in these departments should receive special training (including comparative law and practice aspects) for better understanding and more efficient implementation of novel insolvency / UPPR related concepts.
- iii. **Practical issues with debt to equity swaps** - It should be considered that the Serbian Insolvency Act is amended in order to make clear that if a debt to equity swap is approved by creditors as a measure of the UPPR, the existing shareholders do not have the right to asked to additionally approve such debt to equity swap.

Other recommendations:

PIT Law should be amended in relation to shares granted to employees by the employer's related party in a way which should ensure its consistent and straightforward application. In this respect, PIT Law should clearly define who is considered payer of income and when taxable event occurs. In our opinion, it would be more convenient to levy burden of calculation and payment of salary tax to individuals who receive the shares and to delete provisions which refer to the moment of taxable event if employer bears the cost. Proposed setup would in our view provide that calculation and payment of salary tax is done by individuals which possess all of the relevant information for calculation and payment.

In addition to the above stated, relevant legislation should explicitly define that tax and SSC base in case of receiving shares from employer's related party registered abroad is equal to market of shares (not increased for tax and SSC) at the acquisition date (when the disposal rights over shares is transferred to employees).

6 Appendix - Accounting treatment of NPL sales

6.1 Derecognition criteria

1 Consolidate all subsidiaries (including SPEs/SPVs)

The question of whether the Bank is preparing consolidated or individual financial statements is important, and the first one, because that affects derecognition criteria. More precisely, even though there might be a legal sale to the SPV, controlled by the Bank, there would be no sale for IAS 39 accounting purposes from the perspective of the consolidated group.

In consolidated financial statements, the derecognition criteria are applied at a consolidated level. This avoids the unnecessary consideration of transactions between individual entities in a group, the effect of which is eliminated on consolidation. Therefore, if financial instruments are transferred within a group, then the consolidated financial statements will not reflect derecognition for intra-group transfers, even if those transfers qualify for derecognition in the individual financial statements of the entity that is the transferor.

Accordingly, when derecognition is assessed at the consolidated level, the issue of whether the transferring entity (the transferor) consolidates the receiving entity (the transferee) or vice versa has a significant impact on the accounting.

2 Determine whether the flowchart should be applied to a part or all of an asset

A financial asset or a group of similar financial assets can be broken down into various parts that can be segregated - e.g. the principal and interest cash flows of a debt instrument - and potentially transferred separately to other parties. Consequently, in applying the derecognition provisions the second step is to determine the financial asset(s) that is (are) subject to possible derecognition.

If an entity transfers its rights to all of the cash flows of a financial asset or a group of similar financial assets, then the derecognition provisions apply to the entire financial asset or group. However, if an entity transfers its rights to only certain cash flows of a financial asset - e.g. the interest cash flows in a debt instrument - or to only certain cash flows of a group of similar financial assets, then it is important to determine the financial asset or assets to which the derecognition provisions apply.

In our view, when rights to some but not all of the cash flows of a financial asset are transferred, judgment may be required to determine whether the cash flows transferred are considered specifically identified. This judgment should include an assessment of whether the rights to the instalments transferred contain risks and rewards related to the rights to instalments retained.

To determine whether the cash flows transferred are specifically identified, the entity should examine the original contract and the transfer agreement to assess whether the cash flows transferred are in substance separate cash flows that are distinct from other cash flows in the original contract, including considering how cash receipts are allocated between the interests of the transferor and transferee.

In our view, in order to be considered specifically identified, the cash flows should be identified as substantively separate cash flows in the terms of the contract between the debtor and the creditor; by contrast, a portion of cash flows that is not specified in the terms of the financial asset and is created in the transfer agreement - e.g. for the purpose of providing a credit enhancement or subordination - does not constitute specifically identified cash flows. For example, if a loan agreement contains a single repayment of obligation of 100, then the right to the first 60 of repayment is not considered specifically identified because the loan agreement does not specify this amount of 60 as a separate cash flow.

Entity applies the derecognition provisions only to a fully proportionate share if it transfers the following:

- only a fully proportionate share of the cash flows of a financial asset (or of a group of similar financial assets); or
- only a fully proportionate share of specifically identified cash flows as explained in paragraphs above.

In order to consider only the part(s) transferred for derecognition as a fully proportionate share, it is important to ensure that the transferring entity also retains only a fully proportionate share of the cash flows. This is why distinction should be made between proportionate share and portion of cash flows. For example, the above treatment would not be valid if the entity would transfer rights to certain % of cash flows but still would cover up to certain % of credit losses.

IAS 39 indicates that the derecognition assessment may be applied either to an individual financial asset or to a portfolio of similar financial assets. However, the standard does not specify the circumstances in which a portfolio assessment is appropriate.

In our view, if in a transfer there are contractual terms that have an effect on the risks and rewards of a group of financial assets, then the group of financial assets rather than each individual financial asset should be assessed for derecognition. Generally, the existence of such contractual terms is evidence that the financial assets are similar and share similar risks and rewards.

3 Evaluating whether contractual rights to cash flows have expired

Once the entity has determined at what level (entity or consolidated) it is applying the derecognition requirements and to what identified asset (individual, group or component) those requirements should apply, it can start assessing whether derecognition of the asset is appropriate.

When the contractual rights to cash flows from the asset have expired, that asset is derecognised and no further analysis is required. Derecognition at this step is generally obvious and requires little or no analysis.

However, a financial asset may be modified or replaced as part of a transaction with the same counterparty. For example, when a borrower is in financial difficulties, the borrower and its creditors may negotiate a restructuring of some or all of the borrower's obligations to allow the borrower sufficient capacity to service the debt or refinance the contract, either entirely or partially. Such circumstances are often referred to as 'forbearance'. Examples of forbearance practices include reducing interest rates, delaying the payment of principal and amending covenants.

In such situations, in our view the holder of the financial asset should perform a quantitative and qualitative evaluation of whether the cash flows of the original financial asset and the modified or replacement financial asset are substantially different. If the cash flows are substantially different, then the contractual rights to cash flows from the original financial asset should be deemed to have expired.

If the terms of a financial asset carried at amortised cost are renegotiated or otherwise modified because of financial difficulties of the borrower or issuer, then any impairment is measured using the effective interest rate before the modification of terms. In other words, even if the asset is derecognised, an impairment assessment is made and an impairment loss is recognised if necessary, before derecognising the asset. In our view, this requirement to assess impairment applies irrespective of whether the modification of the existing asset leads to its derecognition.

4 Evaluating whether there is a transfer

A financial asset qualifies for derecognition under IAS 39, either if the contractual rights to the cash flows from that financial asset expire or if an entity transfers a financial asset in a transfer that meets the criteria for derecognition specified in the standard. An entity transfers a financial asset if, and only if, it transfers the contractual rights to receive the cash flows of the financial asset or it enters into a qualifying pass-through arrangement.

In our view, to be considered a transfer of the contractual rights to receive the cash flows of the financial asset, the transfer of legal title should result in a transfer of all existing rights associated with the financial asset without any additional restrictions being imposed as a result of the transfer. A right to demand payment or to obtain legal title that is conditional on the transferor defaulting under a servicing agreement does not constitute a transfer of contractual rights. In this case, whether there is a transfer is evaluated using the **pass-through requirements**.

Pass-through requirements – additional considerations

A transferor may continue to administer or provide servicing for assets that it has previously transferred to another entity. For example, a transferor may transfer all rights to receivables but then continue to collect the cash flows of those receivables as a servicer in the capacity of an agent of the transferee. The determination of whether the contractual rights to cash flows have been transferred is not affected by the transferor retaining the role of agent to collect the cash flows of the receivables in this case. Therefore, retention of the servicing rights by the entity transferring the financial asset does not in itself cause the transfer to fail the requirements of derecognition criteria.

However, depending on the legal environment in which an entity operates and the contractually agreed terms, there may be circumstances in which it is not clear whether the contractual rights to receive the cash flows of the financial asset have been transferred. For example, the beneficial interests in a receivable could be sold without legal title to the financial asset being transferred; the seller avoids having to notify the debtor of the sale, thereby retaining its relationship with the debtor, and the debtor continues to make payments directly to the seller. In the event of breach, the buyer has the right to 'perfect' the sale by acquiring legal title to the receivables. In such circumstances, whether a transfer has taken place is a question of fact, viewed together with the legal environment in which the entity operates, and requires the use of judgment.

In our view, for a transfer of contractual rights to take place, the transferee should have an unconditional right to demand payment from the original debtor in the case of default by the original debtor.

If an **entity retains the contractual right to the cash flows** of a financial asset, but also **assumes a contractual obligation to pay the cash flows** to the transferee (sometimes called a 'pass-through arrangement'), then the transaction is considered a transfer if and only if:

- a. the entity has no obligation to pay amounts to the transferee unless the entity collects equivalent amounts from the original financial asset;
- b. the entity is prohibited from selling or pledging the original financial asset under the terms of the pass-through arrangement; and
- c. the entity is obliged to remit all of the cash flows that it collects without material delay.

Example:

Bank enters into an agreement with Company N in respect of a loan:

- **Legal title** to the loan and collateral are **retained** by the Bank, but it agrees to **pass** any **cash flows** generated by the loan to N immediately;
- There is no obligation for B to pay any amount to N other than the cash that it receives on the loan - i.e. neither the principal nor any interest in the case of late payment.
- The agreement prohibits N from selling the loan or the accompanying collateral

In this example, the transaction **qualifies** as a **transfer** because it meets the pass-through criteria.

The next step is for N to evaluate whether it has transferred or retained the risks and rewards of ownership

5 Risk and rewards evaluation

For all transactions that meet the transfer requirements, the entity next evaluates whether it has transferred or retained the risks and rewards of ownership of the financial asset. An entity derecognises a transferred financial asset if it has transferred substantially all of the risks and rewards of ownership of that asset. Conversely, it continues to recognize a transferred financial asset if it has retained substantially all of the risks and rewards of ownership of that asset. However, if an entity, based on the outcome of the risks and rewards evaluation, has neither transferred nor retained substantially all of the risks and rewards of ownership of a transferred asset, then it determines whether it has retained control of that asset to assess whether derecognition is appropriate.

The risks and rewards analysis is performed by comparing the entity's exposure, before and after the transfer, to the variability in the present value of the future net cash flows from the financial asset.

Therefore, for each type of risk or for all of the risks transferred and retained, an entity determines its exposure to the variability in the amounts and timing of the net cash flows of the transferred asset arising from that type of risk or from all of the risks. Even if individual risk types are considered separately, the evaluation of whether an entity has transferred or retained substantially all of the risks and rewards is based on the aggregate exposure arising from all risk types.

Therefore, for each type of risk or for all of the risks transferred and retained, an entity determines its exposure to the variability in the amounts and timing of the net cash flows of the transferred asset arising from that type of risk or from all of the risks. Even if individual risk types are considered separately, the evaluation of whether an entity has transferred or retained substantially all of the risks and rewards is based on the aggregate exposure arising from all risk types.

Example:

Bank enters two separate transactions:

- It transfers financial assets to unconsolidated Structured Entity SE. The consideration for the transfer includes a note that represents an interest in the transferred assets.
- Subsequently, Bank sells the note unconditionally to an unrelated third party (Company X) and retains no further involvement with the transferred financial assets or SE.

Bank **evaluates** the **risks** and **rewards** of its interests in the financial assets on a cumulative basis as follows:

- At the date of the first transaction with SE, **Bank** concludes that it **has retained** substantially all of the **risks** and **rewards** of ownership of the transferred assets because it obtains the note that represents an interest in the transferred assets. Accordingly, Bank **does not derecognise** the transferred financial assets at this time.
- At the date of the second transaction with X, Bank considers the subsequent sale and concludes that it has transferred substantially all of the risks and rewards of ownership of the financial assets and derecognises them.

Risks inherent in debt instruments to be considered:

- Credit risk, also called “default risk” or “risk of default”;
- Interest rate risk, comprising fair value interest rate risk and cash flow interest rate risk;
- Prepayment risk - i.e. the risk that the principal is repaid earlier than expected – which is not defined in IFRS; and
- Late-payment risk - i.e. the risk that payments received from the underlying financial assets are made later than expected, sometimes called “slow-payment risk” - which is not defined in IFRS.
- Currency risk
- Other risks - this category covers any risks that may exist in practice in a particular fact pattern that is not explicitly covered by the above risk categories - e.g. dispute and legal risks and structural liquidity risk

No specific quantitative guidance is provided on what constitutes 'substantially all' of the risks and rewards of a financial asset. In our view, the analysis should be based on all of the facts and circumstances, considering all of the risks (except for dispute and legal risks) associated with the financial asset on a probability-weighted basis. If substantially all of the total variability in the present value of the future cash flows associated with the financial asset is retained, then the entity would be

considered to have retained substantially all of the risks and rewards. Assessing whether and to what extent exposure to variability in the present value of cash flows has been retained requires consideration of all relevant facts and circumstances.

Assessing **whether** and to **what extent** exposure to **variability** in the **present value** of **cash flows** has been **retained** requires **consideration** of **all** relevant **facts** and **circumstances**.

If the **transferee** is a **SPV**, then the **consideration** for the transfer often includes **financial instruments** issued by, or other **interests** in, the **SPV**. Usually, the SPV is established for the purpose of holding similar transferred assets and paying the cash flows from such assets to the various interest holders in the SPV in line with the terms of those interests and its governing arrangements. Accordingly, these interests represent a repackaging of some or all of the cash flows of the transferred assets.

The transferor may already have a pre-existing interest in the limited-purpose vehicle, such as subordinated debt or an equity-like interest, and this pre-existing interest may also represent an exposure to variability in the cash flows of newly transferred assets that is relevant to the analysis.

In **our view**, in these cases the analysis should **focus** on **comparing** the **variability** of the **cash flows** of the **transferred assets** with the **variability** of the **cash flows** of the **financial instruments received** as consideration for the transfer. This assessment should include consideration of any agreements such as a guarantee or put or call options related to the transferred assets and need not consider ordinary equity interests that the transferor already held in the transferee.

If **financial assets** are **transferred** to a SPV in exchange for new equity interests in the transferee, then the transferor **evaluates** the **nature** of the **variability** to which those new interests expose it. If the SPV has substantive other operations, then the variability in discretionary dividends and changes in fair value arising from the new equity interests would usually be significantly different from an exposure to the transferred assets. In some cases, this may require consideration of the transferee's future plans - e.g. if the transferee is a start-up company.

The **smaller** the **transferred assets** are in relation to the **total operations** of the SPV and the smaller the new equity interests are in relation to the total ownership interests in the SPV, the **more likely** it is that substantially all of the **risks and rewards** of ownership may be **considered** to have been **transferred**.

In our view, it is not generally necessary to use cash flow and/or similar models in performing a risks and rewards analysis. In most cases, evaluating the terms and conditions of the transaction should be enough to determine whether, and to what extent, an entity's exposure to variability in the amounts and timing of the net cash flows has changed as a result of the transfer.

However, under certain circumstances a degree of statistical analysis might be required. For example, in transactions in which the transferor and the transferee share the exposure to the variability in cash flows arising from credit risk, it might be difficult to determine whether substantially all of the risks and rewards have been transferred.

Example:

Bank transfers short-term receivables of 100 to Company S for 95. There is no significant risk other than credit risk inherent in the receivables and the default rates are as follows:

- expected credit losses are 5% of the notional amount; and
- the likely range of losses is between 4.5% and 6.5% of the notional amount, with a 99.9% confidence interval.

Bank provides a **guarantee** to reimburse S for **losses exceeding 6.5%**. The risk is that actual credit losses may exceed the expected credit losses of 5%. The rewards, which remain with S, are that actual credit losses may be less than the expected credit losses of 5%.

Bank concludes that **it has transferred** substantially all of the **risks** and **rewards** associated with the receivables, because R is **not exposed** to the **variability** in **cash flows** within the range of **reasonably possible outcomes**.

In some cases, it is possible that a third party instead of the transferor provides credit enhancement. In our view, if the transferor is the beneficiary of the credit enhancement contract, but agrees to compensate the transferee for credit losses, then this is an indication that the transferor has retained the credit risk. In this case, the credit enhancement contract should be disregarded in evaluating whether the financial assets qualify for derecognition and it should be assumed that the transferor continues to bear the credit risk. To transfer the credit risk inherent in the financial assets, in our view the transferee needs to be the beneficiary under the credit enhancement contract and not the transferor.

Also, in evaluating risks and rewards it is important that the entity not only transfers substantial rewards but also that it transfers its exposure to a significant loss arising from a substantial risk. A risk of loss could be considered 'significant', for example, if it is based on historical loss experience for the type of financial asset transferred. For example, if a transfer of credit risk, which is generally considered to be a substantial risk of the financial assets transferred, will happen only in a catastrophe or similar situation because historical losses are covered through a guarantee by the transferor, then this is considered to be outside the range of likely loss outcomes. This would not be considered a transfer of a significant exposure to loss from credit risk.

6 Control evaluation

If an entity neither transfers nor retains substantially all of the risks and rewards of ownership of a financial asset, then it evaluates whether it has retained control of the financial asset. If the entity has not retained control of the asset, then it derecognises that asset. Conversely, if the entity has retained control, then it continues to recognize the asset to the extent of its continuing involvement in the financial asset.

An entity is considered to have lost control if the transferee has the practical ability unilaterally to sell the transferred financial asset in its entirety to an unrelated third party without needing to impose additional restrictions on the sale. If there is an active market for the financial asset, then the transferee often has the practical ability to sell the financial asset, even if the contractual arrangements between the transferor and the transferee could require the transferee to return the financial asset to the transferor - e.g. if the financial asset is subject to an option that allows the transferor to repurchase it but the financial asset is readily obtainable in the market. Conversely, the transferee does not usually have the practical ability to sell the financial asset if there is no market for the financial asset, even if the contractual arrangements between the transferor and transferee permit such a sale.

In our view, determining whether there is a market for the financial asset and whether the transferee has the practical ability to sell in that market is a matter of judgment based on consideration of the facts and circumstances. It is not necessary in all cases to demonstrate that the market for the financial asset is active or organized. We believe that a market may be considered to exist if there are willing buyers for an asset and a sale to a market participant could be effected within a reasonable timescale and at a reasonable cost.

Example:

Bank sells a portfolio of corporate loans to Company B and **simultaneously enters** into a **call option** with B under which it has the right to repurchase the financial assets after five years.

Although **B** has the **legal right** to **sell** the financial assets, it **does not have the practical ability** to do so because it could be required to return them to the Bank at the end of five years. Should B attempt to sell the financial assets to another party, it would have to attach a similar call option to be able to repurchase the financial assets in the event of Bank exercising its option. It is also unlikely that there is an active market for such financial assets that would allow B to sell the financial assets without attaching the aforementioned call option to them. Consequently, **because** of the **call option** held by the Bank, in our view it has **retained control** over the financial assets and will have to **consider accounting** under **continuing involvement** in the financial asset.

If an entity retains control of a financial asset for which some but not substantially all of the risks and rewards have been transferred, then the entity continues to recognize the financial asset to the extent

of its continuing involvement. If an entity's continuing involvement in a transferred asset takes the form of a guarantee, then the extent of the entity's continuing involvement is the lower of: (1) the carrying amount of the asset; and (2) the maximum amount of the consideration received that the entity could be required to repay.

Example:

Bank transfers short-term receivables of 100 to Company Q. Bank **provides a credit loss guarantee** of 2. Expected credit losses are 4 and historically have varied between 1 and 5. Q is not permitted to sell or pledge the receivables.

In our view, **Bank has retained some**, but **not** substantially **all**, of the **risks and rewards** of ownership associated with the receivables. In addition, Q is not permitted to sell or pledge the receivables and there is no market for such receivables. Therefore, **Bank has not given up control** and **continues to recognize** the receivables to the extent of its continuing involvement.

Generally, a measurement based on continuing involvement requires the net carrying amount of the financial asset and the associated financial liability to reflect, depending on the measurement basis of the financial asset, either the amortised cost or the fair value of the rights and obligations retained by the entity. However, notwithstanding the requirement to arrive at a particular net carrying amount, the financial asset and associated financial liability might not qualify for offsetting.

7 Other consideration in case transfer qualifies for derecognition

Sometimes new financial assets or financial liabilities are created in the transfer - e.g. a credit guarantee. New financial assets, financial liabilities or servicing liabilities created as a result of the transfer are recognised separately and measured at fair value.

A gain or loss is recognised based on the difference between (1) the carrying amount of the financial asset (or part of the financial asset) derecognised; and (2) the consideration received (including any new asset obtained less any new liability assumed), and the cumulative gain or loss previously recognised in OCI in respect of the derecognised financial asset or the part of the derecognised financial asset. If financial assets are exchanged in a transaction that meets the criteria for derecognition, then the financial assets received are measured at fair value and the profit or loss on disposal is calculated based on the fair value of the financial assets received.

8 Other consideration in case transfer qualifies for derecognition

If a transfer does not qualify for derecognition, then the financial asset, or the retained portion of the financial asset, remains in the statement of financial position and a corresponding financial liability is recognised for any consideration received.

If contractual rights and obligations - e.g. derivatives - related to a transfer prevent the transferor from derecognising the financial assets, then these rights and obligations are not accounted for separately.

For example, a call option retained by the transferor may prevent the derecognition of certain financial assets, but recognising the financial assets as well as the call option would result in the entity double counting its rights to those financial assets.

Example:

Bank transfers receivables of 100 to Company Y in exchange for a **note** amounting to 100 that represents a **beneficial interest** in the **transferred assets** - i.e. payments on the note will be made only out of cash collected from the receivables.

Bank **does not derecognize** the receivables because the **note effectively passes substantially all of the risks and rewards** of ownership of the receivables back to Bank.

In addition, Bank does not recognize a new asset for the right to receive cash flows from the note, because doing so would result in double counting the rights to the transferred receivables. Except for this retained interest in the transferred receivables, which are already recognised in X's statement of financial position, Bank has retained no consideration for the transfer. Because no new asset is recognised, neither is any corresponding financial liability.

6.1.1 Accounting from transferee and investors' perspective

Accounting from the transferee's perspective

If a transfer of a financial asset does not qualify for derecognition, then the transferee does not recognize the transferred asset as its asset in its statement of financial position. Instead, the transferee derecognizes the cash or other consideration paid and recognizes a receivable from the transferor.

IAS 39 is silent on the accounting by the transferee for transactions that do not qualify for derecognition by the transferor when the transferee does not pay cash or other assets but instead issues a new debt instrument as consideration for the assets transferred.

In our view, the transferee should usually recognize both a receivable from the transferor as a financial asset and the debt instrument as a financial liability in such cases. This is because the terms of each instrument generally determine the appropriate accounting and two financial instruments, even if they are entered into simultaneously, are accounted for separately.

Receivables sold with full recourse do not generally qualify for derecognition. Instead, the transaction is generally accounted for by the transferor as a collateralized borrowing.

Investor's (SPV) perspective

Acquiring loan portfolios can involve complex accounting issues or a need to apply general accounting guidance to the specific circumstances of a business combination or a direct loan acquisition.

On an acquisition of loans, key items for investors to consider include the following:

- The amount to be recognised initially, taking into account the transaction price, the items included in the acquisition and the investors' process to determine fair value;
- How to subsequently measure the loans, including how to differentiate the impact of cash flow changes between interest income and impairment losses when the loans are measured at amortised cost. Such a consideration needs to be made when the acquisition includes loans acquired at a deep discount that reflects incurred credit losses, as well as when it does not;
- The treatment of any loan commitments acquired or indemnities/guarantees received in relation to the acquisition.

At what amount should acquired loans be recognised initially?

Loans, whether acquired as part of a business combination or acquired in a direct asset purchase, are measured initially by the purchaser at their fair value at the acquisition date. In general, fair value is determined on an individual loan basis.

In our view, the requirement to recognise all financial assets at fair value initially applies to all loans, including those purchased from related parties.

If a loan from a related party is not on market terms, then the purchaser should consider the appropriate accounting taking into account all terms and conditions of the loan.

Is acquisition price always the same as fair value at the acquisition date?

Normally, the fair value at initial recognition is the transaction price, i.e. the amount of consideration given or received. However, if the transaction is not based on market terms, then the consideration given may include compensation for something in addition to the loans. If no market prices are observable for such a transaction, then it is necessary to use a valuation technique to determine the appropriate fair value for initial recognition of the loans.

Can fair value be calculated on a portfolio basis?

Generally, fair value is determined on an instrument-by-instrument basis. However, in our view in some cases a portfolio valuation approach may be appropriate as a practical expedient in order to determine the sum of the fair values of the constituent individual instruments within a portfolio.

One of these **examples** is a **portfolio of non-performing loans**. Due to the nature of the loans, generally no quoted prices for identical individual loans are available in an active market. Therefore, in an orderly transaction that is based solely on inputs from observable markets, and absent any

evidence to the contrary, it **may be argued** that the **transaction price** for the **portfolio** represents the best evidence of the **sum** of the **fair values** of the **individual loans**. In such a case, it **may be appropriate** to measure the **fair value** of the **entire portfolio** based on the portfolio's **transaction price**. The fair value of the portfolio would reflect a market participant's view with respect to relevant valuation parameters, such as discount rates and expected losses at a portfolio level.

If an acquired loan is impaired, then can the purchaser set up an impairment allowance on the date of acquisition?

In our view, it is not appropriate to set up an impairment allowance account on the initial recognition of a loan or a portfolio of loans. Impairment is recognised only if there is objective evidence of impairment as a result of events that occur after the initial recognition of the assets.

How are acquired loans classified at initial recognition?

At initial recognition, a loan is classified into one of the measurement categories for financial assets set out in IAS 39. The classification is based on conditions that exist on the date of the purchase or business combination, i.e. the date on which the purchaser first becomes party to the loan's contractual provisions, and may be different from the classification in the seller's financial statements. Initial classification determines the subsequent measurement of the asset in the financial statements.

A loan normally would be classified as a loan and receivable, but might also qualify as a financial asset at fair value through profit or loss or be classified as an available-for-sale financial asset. However, the presence of an embedded derivative within the loan contract may affect its classification.

Loans and receivables

Typically, banks use the loans and receivables classification category to measure the loans subsequently at amortised cost. The only other amortised cost measurement category is held-to-maturity investments. However, it contains more restrictions, as discussed below, and cannot be used if the acquired assets meet the definition of loans and receivables.

Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market, other than:

- those that the entity intends to sell immediately or in the near term, which are classified as held for trading, and those that the entity designates at fair value through profit or loss on initial recognition;
- those that the entity designates as available for sale on initial recognition; and
- those for which the entity may not recover substantially all of its initial investment, other than because of credit deterioration, which are classified as available for sale.

Both originated and purchased loans may be classified as loans and receivables.

Financial assets at fair value through profit or loss

Alternatively, acquired loans may be classified as financial assets at fair value through profit or loss. A loan is classified as at fair value through profit or loss if it is held for trading or if it is designated into the fair value through profit or loss category at acquisition.

The held-for-trading classification is mandatory if the loan meets one of the following conditions:

- it is acquired principally for the purpose of selling it in the near term; or
- on initial recognition, it is part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking.

A loan also may be designated by the entity as at fair value through profit or loss on initial recognition. An entity may use this designation only when the loan contains a separable embedded derivative.

Available-for-sale financial assets

In addition, an entity has a free choice of classifying any loan, other than one that is held for trading, as available for sale at initial recognition.

When does an embedded derivative require separation?

An embedded derivative is required to be separated from the host contract, e.g. a loan, and accounted for as a stand-alone derivative if all of the following conditions are met:

- the economic characteristics and risks of the embedded derivative are not closely related to those of the host contract (see below);
- a separate instrument with the same terms as the embedded derivative would meet the definition of a derivative (defined in IAS 39.9); and
- the hybrid (combined) instrument, e.g. loan containing an embedded derivative, is not measured at fair value with changes in fair value recognised in profit or loss.

If none of these three conditions is met, then separate accounting for the host and the embedded derivative is not permitted.

How are loans measured subsequent to initial recognition?

The subsequent measurement of loans depends on their initial classification. Loans classified as loans

and receivables are measured subsequently at amortised cost using the effective interest method, while those classified as financial assets at fair value through profit or loss and available-for sale financial assets are measured subsequently at their fair values.

For financial assets at fair value through profit or loss, fair value changes are included in profit or loss. If interest income is presented separately from other fair value changes, then it is measured on an effective interest basis and presented as interest income.

For available-for-sale loan assets, fair value changes (being the difference between amortised cost and fair value) are presented in other comprehensive income. Interest, calculated using the effective interest method, impairment losses and foreign exchange gains and losses (because loans are generally monetary items) are recognised in profit or loss.

Effective interest rate

An effective interest rate calculation is required to determine interest income for all financial instruments measured at amortised cost or classified as available for sale, or if interest on fair value through profit or loss instruments is presented separately from other fair value changes. Therefore, at the acquisition date, the fair value determined for the loans and the total cash flows expected over the remaining term of the loans are used by the purchaser to calculate an effective interest rate for the loans. This new effective interest rate should be used to determine subsequent interest income in the purchaser's consolidated financial statements, but has no impact on the acquiree's accounting in its own financial statements.

The effective interest rate is calculated on initial recognition of a loan and reflects a constant periodic return on the carrying amount of the loans. It is the rate that exactly discounts estimated future receipts through the expected life of the loan, or when appropriate a shorter period, to the net carrying amount of the loan on initial recognition. The calculation of the effective interest rate includes all fees and points paid or received between the contracting parties that are an integral part of the effective interest rate, as well as transaction costs and all other premiums or discounts. There is a presumption that the cash flows and the expected life of a loan, or a portfolio consisting of similar loans, can be estimated reliably.

The calculation of the effective interest rate takes into account the estimated cash flows, which consider all contractual terms of the loan, but without inclusion of future credit losses. However, if an entity acquires financial assets at a deep discount that reflects incurred credit losses, then it includes the incurred credit losses in the estimated cash flows when computing the effective interest rate.

Calculating impairment losses

Just like in case of originated loan, subsequent to initial recognition, the Entity assesses its loans and receivables for impairment calculation purposes.

If there is objective evidence that a financial asset is impaired, then an entity determines the amount of any impairment loss. It first assesses whether objective evidence of impairment exists individually for financial assets that are individually significant, and individually or collectively for financial assets that are not individually significant. If the entity determines that no objective evidence of impairment exists for an individually assessed financial asset, whether it is significant or not, then it includes the asset in a group of financial assets with similar credit risk characteristics and collectively assesses them for impairment.

The measurement of the impairment loss differs for assets carried at amortised cost and available-for-sale financial assets. For a loan carried at amortised cost, impairment is measured as the difference between the loan's carrying amount and the present value of estimated future cash flows discounted using the original effective interest rate (effective interest rate calculated at initial recognition after the transfer).

However, for a loan classified as available for sale, an impairment loss is calculated as the difference between the loan's amortised cost and its fair value, which reflects market interest rates and market expectations of expected future, as well as incurred, credit losses.

The estimated future cash flows determined for assets carried at amortised cost assessed for impairment on a collective basis are discounted at a rate that approximates the original effective interest rate. For portfolios of similar loans, the assets will have a range of interest rates and therefore judgement is necessary to determine a discounting methodology appropriate to that portfolio. This may result in using the average effective yield if it is a homogeneous portfolio.

The estimated future cash flows include only those credit losses that have been incurred at the time of the impairment loss calculation. Losses expected as a result of future events, no matter how likely, are not taken into account. This is particularly relevant when loans are evaluated for impairment collectively.

If, in a subsequent period, the amount of any impairment loss of a loan or group of loans measured at amortised cost decreases due to an event occurring subsequent to the write-down, then the previously recognised impairment loss is reversed through profit or loss with a corresponding increase in the carrying amount of the underlying asset(s). The reversal is limited to an amount that does not state the asset at more than what its amortised cost would have been in the absence of impairment. Also, in our view, to the extent that the incurred loss has never been recognised by the purchaser of the asset in profit or loss, the purchaser cannot subsequently present such increase in cash flows as a reversal of impairment.

Acquiring a loan portfolio at a deep discount that reflects incurred credit losses

As discussed above, future expected credit losses are not taken into account by the purchaser in determining the effective interest rate for the portfolio at acquisition because doing otherwise would be a departure from the incurred loss model for impairment. Therefore, the amortised cost calculation cannot be used to remove credit spread from interest income to cover future losses.

However, if a financial asset is acquired at a deep discount that reflects incurred credit losses, then such credit losses are included in the estimated cash flows when computing the effective interest rate. Therefore, for a loan portfolio that is impaired at the acquisition date, the estimated cash flows are determined on the basis of the expected receipts after reduction for incurred credit losses, rather than on the basis of the cash flows that would arise if borrowers complied with the full contractual terms. Generally, the expected cash flows should exclude any future credit losses, i.e. those expected in addition to the losses incurred at the acquisition date. In practice, it may be difficult to make a

distinction between incurred and future losses for assets that are already impaired. However, to the extent that the distinction can be made, future losses should be excluded from the estimates.

The re-estimation of future cash flows can be performed on a loan-by-loan basis or on a portfolio basis. In some cases, the acquisition of a large group of loans may consist of more than one portfolio of homogenous loans, i.e. loans with similar terms, interest rates etc. When portfolios of loans are acquired inclusive of incurred credit losses, the treatment of the subsequent revisions to cash flows gives rise to some accounting complexities because it is necessary to separate revisions to cash flows that relate to impairment from other revisions in estimates. The purchaser therefore has to keep sufficiently granular records. Changes in cash flow estimates generally are presented as part of interest income unless there is subsequent evidence of impairment, in which case the changes generally are presented as impairment losses or reversals of impairment in the impairment charge line in profit or loss.

6.2 Repossessed assets accounting treatment

Reposessed assets held at Banks should be regarded as part of the NPL issue in the market. In accordance with the NBS' Decision on classification of bank balance sheet assets and off-balance sheet items, assets acquired through collection of receivables are a subject to classification and are treated as "risky".

In accordance with this decision, Property acquired through collection of receivables (foreclosure) shall not be classified during the period of three years following the maturity date of those receivables, provided that:

- at the moment of acquisition the bank has an appraisal of the property's market value which is not older than a year;
- the bank has the market value of the acquired property assessed at least once a year during the above period.

In such manner, by defining a starting period from the maturity of these receivables and not the date of acquisition, NBS has wanted to stimulate banks to take action in order to dispose these assets. In case if banks were reluctant to do so, these assets would have the same treatment as initial NPL loans for which they served as a collateral.

Apart from the Decision on classification, these assets should be tested for impairment as in accordance with IAS 36.

Accounting treatment of repossessed assets transfer – Bank

On disposal of assets, the Bank ceases to recognize the property in its books and recognizes a gain or loss arising on derecognition as the difference between the net sales price and carrying value of the asset on the books. These gains are not treated as revenue if assets were classified as fixed assets in Bank's books.

Received consideration is recognized at its fair value. However, if the Bank classifies the property as held for sale in accordance with IFRS 5, then the gains on sales are recognized as revenue in accordance with IAS 18. The criteria for revenue recognition (IAS 18) are identical in the case that the Bank maintains assets in their books as an investment property.

Accounting treatment of repossessed assets transfer – Investor

After the purchase, the Investor makes the decision how to classify acquired assets in accordance with its intentions. It is most likely that the Investor would classify acquired assets as either investment property or assets available for sale.

An asset should be classified as investment property when it is probable that the future economic benefits that are associated with the property will flow to the entity, and the cost of the property can be reliably measured.

Investment property is initially measured at cost, including transaction costs.

For the purpose of subsequent measurement, the entity can choose between a cost model and a fair value model, which adopts as its accounting policy and one method must be applied to all entity's investment properties. Fair value is determined in accordance with IFRS 13.

The entity that chooses the cost model, measures all its investment property in accordance with the requirements of IAS 16 for this method, except those that meet the requirements to be classified as real estate held for sale (or are included in the group for disposal which is classified as a group held for further sale). These assets shall be measured in accordance with IFRS 5 which requires that these assets are measured at the lower value of the carrying amount and fair value less cost to sell.

An entity shall classify non-current assets (or disposal group) as an asset held for sale if its carrying amount will be recovered principally through a sale transaction rather than through continuing use.

However in order for the entity to be able to classify asset in accordance with IFRS 5 it must be available for immediate sale in its present condition subject only to terms that are usual and customary for sale of such assets and the sale must be highly probable, and an active program to locate a buyer and complete the plan must have been already initiated. Also, non-current asset (or disposal group) must be actively present in the market at a price that is reasonable in relation to its current fair value. In addition, the sale should be expected to qualify for recognition as a completed sale within one year from the date of classification.

Exemption from the time criteria of one year for the realization of assets is possible only if delay is caused by events or circumstances beyond the control of the entities.

The entity recognizes an impairment loss for any initial or subsequent write down of the value of assets (or disposal group) to fair value less costs to sell, to the extent which is not recognized in accordance with paragraph.

An entity shall recognize a gain for any subsequent increase in fair value less costs to sell of an asset, but not in excess of the cumulative impairment loss that has been recognized either in accordance with this IFRS or previously in accordance with IAS 36 Impairment of Assets.

Any subsequent increase in fair value can be recognized only up to the amount of the cumulative loss from reduction in value that has already been recognized.

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Contact us:

KPMG team:

**Moravčević Vojnović i
partneri OAD in cooperation
with Schoenherr team:**

Dušan Tomić

Partner, Financial Services

T +381 11 2050521

E dtomic@kpmg.com

Biljana Bujić

Partner, Tax

T +381 11 2050511

E bbujic@kpmg.com

Matija Vojnović,

Partner

T +381 11 3202600

E m.vojnovic@schoenherr.rs

Uroš Milosavljević

Manager, Financial Services

T +381 11 2050699

E umilosavljevic@kpmg.com

Jelena Miljković

Senior Manager, Tax

T +381 11 2050516

E jmiljkovic@kpmg.com

Petar Kojdić,

Partner

T +381 11 3202600

E p.kojdic@schoenherr.rs

Jovan Barović,

Attorney at Law

T +381 11 3202600

E j.barovic@schoenherr.rs