

2007

## Bank Regulatory Reform in the Republic of Serbia

Gary A. Gegenheimer

Follow this and additional works at: <https://scholarcommons.sc.edu/scjilb>



Part of the [International Law Commons](#)

---

### Recommended Citation

Gegenheimer, Gary A. (2007) "Bank Regulatory Reform in the Republic of Serbia," *South Carolina Journal of International Law and Business*: Vol. 3 : Iss. 2 , Article 2.

Available at: <https://scholarcommons.sc.edu/scjilb/vol3/iss2/2>

This Article is brought to you by the Law Reviews and Journals at Scholar Commons. It has been accepted for inclusion in South Carolina Journal of International Law and Business by an authorized editor of Scholar Commons. For more information, please contact [digres@mailbox.sc.edu](mailto:digres@mailbox.sc.edu).

# BANK REGULATORY REFORM IN THE REPUBLIC OF SERBIA

*Gary A. Gegenheimer*<sup>\*</sup>

- I. Introduction
- II. The Serbian Banking Sector
- III. The Framework for Reform
- IV. Highlights of the New Serbian Banking Legislation
  - A. Bank Ownership and Control
    - 1. Participation in Banks
    - 2. Criteria for Approval: "Fit and Proper" Persons
  - B. Risk Management
  - C. Bank Corporate Governance
    - 1. Governance Structure

---

<sup>\*</sup> Manager and Senior Attorney, Emerging Markets Sector, BearingPoint, Inc., McLean, Virginia. B.A., 1975, Westfield State College; M.A., 1977, Georgetown University; J.D., 1980, University of Maine; LL.M. (International Banking), 1994, Boston University. The author has served as Legal Advisor to the National Bank of Serbia [hereinafter NBS] on a Banking Supervision Project sponsored by the United States Agency for International Development (USAID) from 2001 to the present, and provided extensive assistance with the drafting of the 2005 Banking Law. He is continuing to assist the NBS with drafting regulations to implement the new law. The views expressed in this article are solely those of the author and do not necessarily reflect the views of BearingPoint, Inc., USAID, or the National Bank of Serbia.

This article is dedicated to the men and women of the National Bank of Serbia who participated in the drafting of the new banking law. The author would also like to extend his sincere thanks and appreciation to the support staff of BearingPoint, Inc., Belgrade, Serbia, especially Mirjana Bugarcic, Tomislav Jovanovic, Svetlana Minic and Jasmina Rankovic for their exceptionally hard work in translating numerous drafts of the Banking Law as well as many accompanying policy papers and memoranda. Finally, the author would like to express his gratitude to his BearingPoint colleagues, especially Jimmy Barton, Joel Hefty, Joel Shapiro, Rosa Chiappe, and Scott Calhoun for their support and policy assistance during the drafting process.

2. The Board of Directors and Audit Committee Under the New Law
3. Bank Management
4. Fiduciary Duties of Managers and Board Members
5. Transactions With Related Persons
- D. Consolidated Supervision
  1. The Importance of Consolidated Supervision
  2. Consolidated Supervision and the New Serbian Banking Law
  3. Mixed Activity Groups and the EU Banking Directive
  4. A Suggested Methodology for Dealing With Mixed Activity Groups
- E. External Audits
- F. Prompt Corrective Action and Enforcement Measures
- G. Problem Bank Resolution
  1. What Law Applies?
  2. "Bankruptcy" or "Liquidation:" A Distinction Without a Difference?
  3. Who Can Initiate Proceedings?
  4. Who Oversees the Proceeding?
  5. The Role of Creditors
  6. Interaction Between Court Processes: Administrative and Commercial Courts
  7. Is Commercial Court Involvement Really Necessary?
  8. Mergers of Problem Banks
  9. Receivership and Conservatorship
  10. Bank Reorganizations
- V. Conclusion

## I. INTRODUCTION

In 2005, the Republic of Serbia adopted three laws that collectively represent major steps forward in its quest to establish a world-class banking supervision regime: a new banking law, which took effect in phases in 2006;<sup>1</sup> a new law on bankruptcy and liquidation of banks and insurance companies;<sup>2</sup> and a new law on deposit insurance.<sup>3</sup> The Serbian Banking Law replaces the previous, Milosevich-era banking law, under which the Serbian banking sector previously operated,<sup>4</sup> and reflects many international standards, especially those of the European Union (EU) and the Basel Committee on Banking Supervision (Basel Committee).<sup>5</sup>

This article will summarize the key provisions of the new bank regulatory regime, focusing on the Serbian Banking Law and the Bank Bankruptcy Law. It will indicate where the new regime fits in when evaluated against pertinent EU provisions and the international best practices of banking supervision, and will suggest some specific steps where further work is necessary.

## II. THE SERBIAN BANKING SECTOR

The Serbian banking sector is still relatively small, but has made significant progress in recent years. Until the early 1990s, when Serbia was still part of the wider Yugoslavia, the banking market was generally considered quite progressive and liberal among socialist countries.<sup>6</sup> During the Milosevic era, under a blend of crony-capitalism and old-style socialism, combined with the effects of war and geopolitical strife, Serbia's banking

---

<sup>1</sup>Law on Banks, RS Official Gazette No. 107/2005 (2005), *available at* <http://www.nbs.yu/english/regulations/index.htm> [hereinafter Serbian Banking Law].

<sup>2</sup>Law on Bankruptcy and Liquidation of Banks and Insurance Companies, RS Official Gazette No. 61/2005 (2005) [hereinafter Bank Bankruptcy Law].

<sup>3</sup>Law on Deposit Insurance, RS Official Gazette No. 61/2005 (2005) [hereinafter Deposit Insurance Law].

<sup>4</sup>Law on Banks and Other Financial Organizations (1993, as amended) [hereinafter the 1993 Banking Law].

<sup>5</sup>The Basel Committee is a committee of bank supervisory authorities from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, the United Kingdom and the United States. The Committee provides a forum for cooperation on banking supervisory matters and the improvement of the quality of banking supervision around the world. It normally meets at Basel, Switzerland, at the headquarters of the Bank for International Settlements. Information about the Basel Committee, and its various publications, can be accessed at its website, <http://www.bis.org/bcbs/index.htm>.

<sup>6</sup>See Marianne Kager and Sándor Gardó, *Due for Revival*, THE BANKER, May 2, 2005, at 126.

system was decimated through directed lending to inefficient state-owned enterprises and Milosevic associates, and, in some cases, outright embezzlement.<sup>7</sup> As in many transition economies, extremely loose licensing and capital requirements resulted in a plethora of banks, with the number peaking at 112 in 1995.<sup>8</sup> By the end of Milosevic's tenure as President, the banking system consisted of approximately eighty-three licensed banks, many of which were insolvent.<sup>9</sup>

Following the ouster of Milosevic, the National Bank of Yugoslavia<sup>10</sup> sensed the opportunity to end years of isolation and, with the assistance and support of international development organizations, moved quickly to clean up the banking sector. In early 2001, diagnostic examinations of the country's banks were undertaken. These examinations confirmed that many of the banks had no further economic purpose, due to their legacy of non-performing assets, inadequate human capital and technology, and lack of public trust.<sup>11</sup> Given the

---

<sup>7</sup> *Id.* See generally Aleksandar Pavic, *Why is America Promoting Hague Inquisition?*, WORLDNET DAILY, April 8, 2002, available at [http://www.worldnetdaily.com/news/article.asp?ARTICLE\\_ID=27138](http://www.worldnetdaily.com/news/article.asp?ARTICLE_ID=27138); Ian Traynor, *Search for the Missing Millions*, THE GUARDIAN, March 29, 2001, available at <http://www.guardian.co.uk/yugo/article/0,2763,464934,00.html>.

<sup>8</sup> Kager and Gardó, *supra* note 6.

<sup>9</sup> *Id.*

<sup>10</sup> Until 2003, Serbia and Montenegro comprised the last two remnants of Yugoslavia, which had come into existence at the end of World War I and had essentially ceased to exist by the early 1990s as its component republics declared their independence. In March 2002, the federal parliament resolved to eliminate the name "Yugoslavia" and to create a restructured federal union known as the State Union of Serbia and Montenegro. A new constitution was approved in early 2003. The country's central bank was known as the National Bank of Yugoslavia until 2003 and has since been officially known as the National Bank of Serbia. For convenience, it is generally referred to in this article as the National Bank of Serbia. In 2006, Serbia and Montenegro each declared themselves sovereign independent countries. See Jovana Gec, *Serbia Declares Itself Sovereign State*, WASH. POST, June 5, 2006, at 1; *Serbia Declares Sovereignty*, BELGRADE METROPOLITAN EXECUTIVE NEWSLETTER, June 6, 2006, at 1; Predrag Milic, *Montenegro Declares Independence From Serbia*, WASH. POST, June 4, 2006, at A17; *Montenegro Declares Independence*, BELGRADE METROPOLITAN EXECUTIVE NEWSLETTER, June 5, 2006, at 1. As a practical matter, Montenegro had been operating largely on an independent basis for a number of years even prior to its formal declaration of independence in June of 2006. It even established its own central bank in 2000. See Official Website of the Central Bank of Montenegro, <http://www.cb-mn.org>.

<sup>11</sup> World Bank Report No. 29258-YU: *Serbia and Montenegro – Republic of Serbia. An Agenda for Economic Growth and Employment* 80 (2004) [hereinafter World Bank 2004 Report]. BearingPoint, Inc. (then known as Barents Group of KPMG Consulting, Inc.) conducted the diagnostic assessments under the USAID bank supervision project. The author provided legal support for the diagnostic team.

inability of the budget to re-capitalize the more seriously distressed banks, and the likely negative franchise value of most of them, some twenty-five insolvent banks, representing nearly two-thirds of the assets of the banking system, were closed over the next three years.<sup>12</sup> In early 2002, the National Bank closed the country's four largest banks, which at the time represented nearly 60% of total recorded banking assets at that time.<sup>13</sup> The Bank Rehabilitation Agency, later renamed the Deposit Insurance Agency, was given extended authority to administer banks in bankruptcy.<sup>14</sup> A new accounting law was enacted, making International Accounting Standards (IAS) mandatory for banks beginning in 2003 and for all other companies in 2004.<sup>15</sup>

USAID has been providing assistance under a banking program since 2001. The program originally comprised two elements: a stabilization effort, focused on the assessment and resolution of the twenty-seven largest banks representing roughly 85% of banking sector assets; and a continuing program which seeks to promote institutional and systemic reform and includes on-site, off-site and special supervision. The over-arching objectives of both aspects of this assistance have been to stabilize the financial system, and to promote long-term safety and soundness through the adoption of prudential banking practices.<sup>16</sup>

Over the past several years, the situation has improved significantly. The number of banks has steadily declined during the past five years as insolvent banks have been closed.<sup>17</sup> As of March 31, 2006, there were thirty-nine licensed banks operating in Serbia.<sup>18</sup>

In July 2002, to cover the resolution of Serbian banks' debts to their Paris and London Club creditors the Government of Serbia initiated a debt-for-

---

<sup>12</sup> *Id.*

<sup>13</sup> *Id.*

<sup>14</sup> *Id.* at 95.

<sup>15</sup> *Id.* See Accounting and Auditing Law, FRY Official Gazette, No. 71/2002 (2002), art. 19, art. 44. There are still a number of issues connected with the actual implementation of IAS. See SOUTHEAST EUROPE ENTERPRISE DEVELOPMENT, FACTORING IN SERBIA: FEASIBILITY STUDY UPDATE 33-34 (February 2005), available at [www2.ifc.org/seed/PDFs/Factoring%20Feasibility%20study%20update%20Feb%2005.pdf](http://www2.ifc.org/seed/PDFs/Factoring%20Feasibility%20study%20update%20Feb%2005.pdf).

<sup>16</sup> USAID, Banking System Stabilization & Reform, *supra* note 7.

<sup>17</sup> *Id.*

<sup>18</sup> National Bank of Serbia, Banking Sector in Serbia, First Quarter Report 3 (May 2006), available at <http://www.nbs.yu/english/publications/index.htm> [hereinafter NBS First Quarter 2006 Report].

equity swap.<sup>19</sup> This process culminated in July 2004, with the signing of a “Memorandum of Understanding on the Debt Restructuring Under the NFA and TDFA Between the Republic of Serbia and the International Coordinating Committee,” containing the following terms: (1) a write-off of approximately 62% of the debt; (2) a repayment period of twenty years; and (3) a grace period of five years.<sup>20</sup> In April 2005, Serbia issued a \$1.02 billion bond to conclude the debt-rescheduling deal reached in 2004.<sup>21</sup> This was followed by an additional \$57 million bond issue in late September 2005, under the same terms as the previously issued bonds.<sup>22</sup>

European banks, sensing an opportunity for growth, rushed into the Serbian market through a series of acquisitions.<sup>23</sup> The Serbian banking sector is now dominated by foreign banks. Of the thirty-nine licensed banks, nearly half (nineteen) are majority – owned by foreign shareholders.<sup>24</sup> Raiffeissen, with its parent bank based in Austria, is the country’s largest bank.<sup>25</sup> Italy’s Banca Intesa, Greece’s Alpha Bank, Piraeus Bank, and the National Bank of Greece, Hypo Alpe-Adria Bank and France’s Société Générale are also significant players.<sup>26</sup> By contrast, only nine Serbian banks – less than a quarter of the total – are majority owned by domestic shareholders, and eleven are majority owned by the Republic of Serbia.<sup>27</sup>

The five largest banks hold 50% of the system’s assets; the ten largest banks have a 69% share.<sup>28</sup> As of March 31, 2006, the overall banking sector balance sheet total stood at 850 billion CSD (Serbian dinars). Banks that are

---

<sup>19</sup> See World Bank 2004 Report, *supra* note 11. The “London Club” is a group of the country’s international banking creditors. For a short history of the country’s sovereign debt build-up, see Tania Jakobi, *Case Study: Serbia and Montenegro Sovereign Debt*, INITIATIVE FOR POL’Y DIALOGUE, available at [http://www2.gsb.columbia.edu/ipd/j\\_bankruptcy\\_serbia.html](http://www2.gsb.columbia.edu/ipd/j_bankruptcy_serbia.html) (last visited Nov. 7, 2006).

<sup>20</sup> NBS, Relations With London and Paris Club, available at [http://www.nbs.yu/english/5\\_6.htm](http://www.nbs.yu/english/5_6.htm) (last visited Nov. 11, 2006).

<sup>21</sup> See *Confident Times*, THE BANKER, May 2, 2005, at 118, available at [http://www.thebanker.com/news/fullstory.php/aid/2848/ZConfident\\_times.htm](http://www.thebanker.com/news/fullstory.php/aid/2848/ZConfident_times.htm).

<sup>22</sup> NBS, Relations With London and Paris Club, *supra* note 20.

<sup>23</sup> *Confident Times*, *supra* note 21; Eric Jansson, *Takeover Trend*, THE BANKER, May 2, 2005, at 122.

<sup>24</sup> NBS First Quarter Report 2006, *supra* note 18, at 4. Foreign bank branches are not permitted in Serbia. In order for a foreign bank to conduct banking business in Serbia, it must establish a subsidiary.

<sup>25</sup> *Confident Times*, *supra* note 21.

<sup>26</sup> *Id.*

<sup>27</sup> NBS First Quarter 2006 Report, *supra* note 18, at 4.

<sup>28</sup> *Id.*

majority-owned by foreign entities hold 68.7% of this total.<sup>29</sup> The share held by majority state-owned banks stood at CSD 198 billion, or 23.3%, while banks in majority private domestic ownership accounted for CSD 68 billion, or 8%.<sup>30</sup> The influx of foreign banks has led to a sharp increase in intermediation of credit to the private sector, and, as a result, the financial sector is much better able to support economic growth.<sup>31</sup>

The year 2006 has seen a CSD 48 billion (11%) increase in overall lending activity of the banking sector.<sup>32</sup> The greatest amount of lending is to corporate customers (64.4%) and citizens (29.3%).<sup>33</sup> The highest percentage of deposits consists of household deposits (43.8%), followed by corporate deposits (22.2%) and bank deposits (16.4%).<sup>34</sup> Foreign exchange deposits accounted for 72.3% of all banking sector deposits.<sup>35</sup> According to the NBS, all licensed and actively operating banks meet the NBS capital adequacy requirement as of March 31, 2006.<sup>36</sup>

Serbia achieved 8% growth in GDP in 2004, just behind Estonia.<sup>37</sup> Unfortunately, however, the overall macroeconomic situation still presents major challenges. Inflation is a significant problem, and the dinar is depreciating, which discourages the use of local currency by individuals. As a result, banks have problems in asset-liability management as large, short-term foreign exchange deposits cannot be easily converted into long-term lending in local currency.<sup>38</sup>

The banking sector is supervised by the NBS.<sup>39</sup> The NBS also has responsibility for supervising the insurance and pension sectors under legislation adopted in 2004.<sup>40</sup>

---

<sup>29</sup> *Id.*

<sup>30</sup> *Id.*

<sup>31</sup> See Int'l Monetary Fund IMF Country Report No. 06/96 5 (March 2006), available at <http://www.imf.org/>.

<sup>32</sup> NBS First Quarter 2006 Report, *supra* note 18, at 6.

<sup>33</sup> *Id.*

<sup>34</sup> *Id.* at 7.

<sup>35</sup> *Id.* at 8.

<sup>36</sup> *Id.* at 11.

<sup>37</sup> See Marcin Mazurek, *Banking Market in Serbia 2006*, CEE BANKING SERIES, January 2006, at 4.

<sup>38</sup> *Id.*

<sup>39</sup> Law on the National Bank of Serbia, Official Gazette of the RS No. 72/2003 (2003), as amended by Law Supplementing the Law on the National Bank of Serbia, Official Gazette of the RS No. 55/2004 (2004) art. 4, ¶ 6.

<sup>40</sup> See *id.*; Law on Insurance, Official Gazette of the RS No. 55/2004 (2004) (Serb.); Law on Voluntary Pension Funds, Official Gazette of the RS No. 85/2005



### III. THE FRAMEWORK FOR REFORM

Serbia has aspired to EU membership since the end of the Milosevic era. On September 4, 2002, the Serbian Government established the Council for European Integration as a consultative government body.<sup>41</sup> Its main tasks are to monitor, review, evaluate and streamline the process of Serbia's association to the EU and provide political support to the activities relating to the process.<sup>42</sup> The Council is comprised of a Prime Minister, Deputy Prime Minister, Government Secretary General, eleven ministers and the Secretary General of the European Integration Office. The Council is chaired *ex officio* by the Prime Minister.<sup>43</sup>

On October 14, 2004, the Serbian parliament adopted a Resolution on EU Accession, which clearly stated the commitment of Serbia to join the EU.<sup>44</sup> This was followed up on June 29, 2005 by a similar resolution of the State Union of Serbia and Montenegro.<sup>45</sup> The same month, Serbia adopted a National Strategy for EU Accession.<sup>46</sup> The listed priority items included harmonization of Serbian legislation with that of the EU and improvements in the banking system.<sup>47</sup>

On April 12, 2005, the European Commission approved a Feasibility Report, placing Serbia and Montenegro on a preliminary track for membership of the EU, agreeing to launch negotiations on a "Stabilization and Association Agreement" (SAA).<sup>48</sup> The SAA is the final stage of the EU's Stabilization and Association Process (SAP), the EU's policy for the countries of the Western Balkans region. The SAP is accompanied by a financial assistance

---

(2005) (Serb.). See generally Wolf Theiss, *Serbia and Montenegro: Pension Funds to Strengthen Capital Markets*, 2006 INT'L FIN. L.R. 1 (2006).

<sup>41</sup> See official website of the Council for EU Integration, <http://www.seio.sr.gov.yu/code/navigate.asp?Id=71> (last visited Nov. 7, 2006).

<sup>42</sup> *Id.*

<sup>43</sup> *Id.*

<sup>44</sup> Resolution on Joining European Union (Oct. 14, 2004), available at <http://www.seio.sr.gov.yu/code/navigate.asp?Id=102>.

<sup>45</sup> Resolution on Association of the State Union of Serbia & Montenegro with the European Union (June 29, 2005), available at <http://www.yusurvey.co.yu/products/ys/showSummaryArticle.php?prodId=2067&groupId=6671>.

<sup>46</sup> National Strategy of Serbia for the Serbia and Montenegro's Accession to the European Union (June 2005), available at <http://www.seio.sr.gov.yu/code/navigate.asp?Id=73>

<sup>47</sup> *Id.* at 72-75 (banking), 139 (legislative harmonization).

<sup>48</sup> Council for EU Integration, *supra* note 41. See also official website of the Joint Office for South East Europe (World Bank and European Commission), <http://www.seerecon.org/gen/eu-see.htm> (last visited Nov. 11, 2006).

program; the Community Assistance for Reconstruction, Development and Stabilisation (CARDS). The EU has SAAs with the former Yugoslav Republics of Macedonia and Croatia, and through mid-2006 was negotiating SAAs with Albania in addition to Serbia and Montenegro. A SAA creates a contractual relationship between a country and the EU, and typically includes provisions on the harmonization of the signatory country's laws with the legislation of the EU.<sup>49</sup> Banking legislation is specifically mentioned.<sup>50</sup>

On June 3, 2006, Montenegro declared independence from Serbia.<sup>51</sup> Two days later, Serbia declared itself a separate sovereign state.<sup>52</sup> The EU is now conducting SAA negotiations with Serbia and Montenegro separately.<sup>53</sup>

Banking sector supervision reform is also a major topic of Serbia's discussions with the International Monetary Fund (IMF). Pursuant to a November 29, 2004 Letter of Intent, the NBS was obliged to substantially strengthen financial sector supervision. In particular, the Letter of Intent required the NBS to:

- group all banks and insurance companies according to their respective risk assessment, with their supervisory plans clearly laid out by end November 2004, and cross-check banks' submitted reports against external audit reports by end-2004;...
- [perform] an on-site assessment of the bank posing the largest potential systemic risk . . . by end-2004, and

---

<sup>49</sup> The texts of the existing SAAs are publicly available. See *Stabilisation and Association Agreement Between the European Communities and Their Member States and the Republic of Croatia* (July 9, 2001) arts. 69 and 84, *available at* [http://www.delhrv.cec.eu.int/en/eu\\_and\\_country/saa.pdf](http://www.delhrv.cec.eu.int/en/eu_and_country/saa.pdf); *Stabilisation and Association Agreement Between the European Communities and Their Member States of the One Part and the Former Yugoslav Republic of Macedonia of the Other Part* (March 26, 2001), arts. 68 and 83, *available at* [http://www.delmkd.cec.eu.int/en/eu\\_and\\_fyrom/pdf/saa03\\_01.pdf](http://www.delmkd.cec.eu.int/en/eu_and_fyrom/pdf/saa03_01.pdf). See also *Action Plan for the Approximation of Serbian Legislation With the European Union Law for 2005*, *available at* <http://www.seio.sr.gov.yu/code/navigate.asp?Id=76> [hereinafter *Action Plan 2005*].

<sup>50</sup> See *Action Plan 2005*, *supra* note 49.

<sup>51</sup> See note 10, *supra*.

<sup>52</sup> *Id.*

<sup>53</sup> See *EU to Launch SAA Talks With Montenegro*, BETA-MONITOR: SOUTHEAST EUROPE ECONOMIC REVIEW, June 5, 2006, at 3; *Serbia, Montenegro to Receive Separate EU Negotiating Mandates* (May 31, 2006), *available at* <http://www.euractiv.com/en/enlargement/serbia-montenegro-receive-separate-eu-negotiating-mandates/article-155693>.

[require] the bank . . . [to] adopt a time-bound plan by end-2004 to strengthen internal controls and governance....

- send a clear signal that regulatory forbearance is ceasing, . . . [by] strengthening on-site and off-site supervision, and strictly enforce existing regulations....
- withdraw the license of banks that do not meet the €10 million minimum capital requirement by end-2004, unless they are recapitalized by reputable investors with banking experience or meet the requirement through a merger...
- [require] all banks, insurance and leasing companies . . . [to] publish [financial results] complying with International Accounting Standards (IAS) for 2004 by the end of June 2005.<sup>54</sup>

In drafting the new Serbian Banking Law, Serbia relied heavily on the EU banking-related directives, notably the EU Banking Directive<sup>55</sup> and the EU Financial Conglomerates Directive,<sup>56</sup> while at the same time being careful to avoid a simple “copy and paste” approach. The law is a blend of the relevant EU directives and internal banking legislation of a number of more advanced countries (notably Germany, Austria, Estonia, Croatia, Canada, Australia and the United States) along with some uniquely Serbian provisions. This approach to the EU directives is appropriate and practical. There is, strictly speaking, no single “EU Banking Law,” but rather a series of directives, addressing specific legal issues to be implemented by the governments of the Member States. The principal purpose of these directives is not to provide a comprehensive “code” for banking regulation and supervision, but rather to create certain minimum standards with the goal of promoting free trade and the establishment of banking organizations

---

<sup>54</sup> See *Serbia and Montenegro — Letter of Intent, Memorandum of Economic and Financial Policies, and Technical Memorandum of Understanding* 27 (November 29, 2004), available at <http://www.imf.org/External/NP/LOI/2004/scg/02/index.htm>.

<sup>55</sup> Council Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 Relating to the Taking Up and Pursuit of the Business of Credit Institutions (recast), 2006 O.J. (L 177/1) [hereinafter EU Banking Directive].

<sup>56</sup> Council Directive 2002/87/EC, of the European Parliament and of the Council of 16 December 2002 On the Supplementary Supervision of Credit Institutions, Insurance Undertakings, and Investment Firms in a Financial Conglomerate, 2003 O.J. (L 35/1) [hereinafter EU Financial Conglomerates Directive].

throughout the Member States.<sup>57</sup> Specifically, this entails licensing and supervision of banks only in their respective home countries, with certain aspects of those items being harmonized throughout the EU so that a bank licensed in one Member State will be free to provide banking services throughout the EU under cooperation between the home and host country supervisors. The directives' standards have been implemented in very different ways in different EU Member States, which are in fact at very different stages of development. Even prior to the admission of ten new members in 2004, the EU ran the gamut from Great Britain, France and Germany on one end to Ireland, Portugal and Greece on the other. Many former Soviet-bloc states from Eastern Europe have now become members. Even a cursory examination of the banking legislation of EU Member States reveals wide disparities in the extent of incorporation of the directives' provisions and terminology. The Member States have often varied the precise wording of the directives while retaining their substance (and, in many cases, have adopted stricter and more detailed requirements). The provisions of the directives are quite valuable and on some topics perhaps even sufficient, but they are far from exhaustive. Some topics that are critically important for banking supervision are addressed only tangentially, or not at all, in the EU directives.

The Banking Law thus incorporates material from a number of countries that are particularly good supplements to the EU directives. Germany and Austria offer good models because their banking laws follow many of the provisions of the EU directives quite closely, though both laws are probably more complex and detailed than necessary for Serbia at its present stage of development. Estonia and Latvia, former Soviet republics that were among the 2004 crop of new Member States, both have banking laws that reflect many EU concepts. In particular, Estonia has taken many of the concepts in the directives and written them in a less complex and more "user-friendly" fashion that is suitable for a transition economy. From outside of Europe, the banking legislation of Canada, Australia and the United States contains much useful material that can effectively supplement the EU materials and in some cases provide an alternative approach.

---

<sup>57</sup> Most of the banking-related directives have been adopted on the basis of provisions of the Treaty on Establishing the European Economic Community, Mar. 25, 1957, O.J. (C 157) [hereinafter E.E.C. Treaty] providing for the freedom of commencing and carrying out of independent professions.

#### IV. HIGHLIGHTS OF THE NEW SERBIAN BANKING LEGISLATION

##### A. Bank Ownership and Control

##### 1. Participation in Banks

Under the 1993 Banking Law, criteria for ownership and control of banks were rather perfunctory and mechanical. Prospective founders of banks were required to submit information about their credit ratings and mutual proprietary and control relationships to the NBS as a condition of obtaining a license.<sup>58</sup> Similarly, persons who proposed to acquire more than 15% of the shares of a bank had to receive the approval of the NBS.<sup>59</sup> It was not at all clear, however, whether the NBS had the authority to scrutinize persons who could, in fact, control a bank without some sort of formal share ownership. Although the 1993 Banking Law defined an “acquirer” as including all persons “related by proprietary and managing relations,”<sup>60</sup> this could easily be interpreted as focusing on formal share ownership rather than real influence or control. For banking supervision purposes, the broader concept of “significant influence” or “control” is much more relevant. It is quite possible, in practice, for a person to exert considerable influence over a bank even in the absence of formal share ownership or controlling rights (such as through surreptitious arrangements with the actual shareholders and managers), and it is important that such influence be subject to supervisory oversight.<sup>61</sup>

The new Serbian Banking Law is much clearer on issues of indirect ownership and real influence. It incorporates the European concept of “qualifying holdings,” although the details differ slightly. Under the new Banking Law, the NBS is concerned about bank ownership (or equivalent influence) at three levels, all of which come under the heading of a “participation:”

- a “qualified participation,” defined as:
  - 1) direct or indirect right or ability to realize 5 percent or more of voting rights of a legal entity, and/or direct or indirect ownership of 5 percent or more of capital of such legal entity; or

---

<sup>58</sup> 1993 Banking Law, *supra* note 4, art. 8.

<sup>59</sup> *Id.* at art. 12, ¶ 1.

<sup>60</sup> *Id.* at ¶ 2.

<sup>61</sup> See Bryan D. Stirewalt and Gary A. Gegenheimer, *Consolidated Supervision of Banking Groups in the Former Soviet Republics: A Comparative Examination of the Emerging Trend in Emerging Markets*, 23 ANN. REV. BANKING AND FIN. L. 533, 553-54 (2004).

- 2) the ability in fact to exercise influence over the management of a legal entity or over the business policy of such legal entity.
- a “significant participation,” defined as:
    - 1) direct or indirect right or ability to realize 20 percent or more of voting rights of a legal entity, and/or direct or indirect ownership of 20 percent or more of capital of such legal entity; or
    - 2) the ability in fact to exercise influence over the management of a legal entity or over the business policy of such legal entity;<sup>62</sup> and
  - a “controlling participation,” defined as:
    - 1) direct or indirect right or ability to realize 50 percent or more of voting rights of a legal entity, and/or direct or indirect ownership of 50 percent or more of capital of such legal entity;
    - 2) the ability to elect at least half of the members of the board of directors or other management body in such legal entity; or
    - 3) the ability in fact to exercise dominant influence over the management of a legal entity or over the business policy of such legal entity.<sup>63</sup>

Both the new Serbian Banking Law and the EU Banking Directive thus frame the ownership/control issue in alternate terms of either formal share ownership or actual control or influence, which is appropriate.<sup>64</sup> The principal differences between the Serbian and EU versions are that: (1) the Serbian law adopts a stricter posture by lowering the ownership threshold for supervisory approval to 5%, whereas the EU standard is 10%; and (2) the Serbian law does not refer to “significant” influence, as the EU Banking Directive does, for determining the existence of a qualified or significant participation; the ability

---

<sup>62</sup> Serbian Banking Law, *supra* note 1, art. 2

<sup>63</sup> *Id.*

<sup>64</sup> Compare EU Banking Directive, *supra* note 55, art. 4, ¶11 (defining a “qualifying holding” in terms of either 10% ownership or the ability to exert a “significant influence” over an undertaking); *id.*, ¶¶9, 12, and 13 (defining “control” in terms of 50% ownership or the ability to exert a “dominant influence”).

to exert *any* degree of influence over an entity - no matter how slight - is sufficient to support a determination that the person in question holds a qualified or significant participation in the entity, and if the entity is a bank or controls a bank, the supervisory approval requirements become applicable.

The Serbian drafters did avoid one drafting mistake in the EU formulation, which has long been one of this author's "pet peeves" with the EU approach.<sup>65</sup> The EU Banking Directive defines a "qualifying holding" as: "[A] direct or indirect holding in an undertaking which represents [ten] percent or more of the undertaking's capital or voting rights, or which makes it possible to exercise a significant influence over the management of the undertaking in which a holding subsists."<sup>66</sup> Under this definition, the "significant influence" test does not become applicable unless there is first a "direct or indirect holding" in the bank. This could easily be interpreted as requiring at least some formal share ownership, either directly or indirectly through other entities, before a "significant influence" analysis could even be considered. This approach is less than satisfactory. In this author's view, any person who can significantly influence a bank should be regarded as having a "qualifying holding" in that bank regardless of the size of that person's ownership of a bank's capital or voting rights.<sup>67</sup> Indeed, other parts of the EU Banking Directive, as well as the Financial Conglomerates Directive, expressly recognize that a person can exert a significant influence over an entity without holding any participation or capital ties at all.<sup>68</sup> The Serbian Banking Law avoids this problem by defining "indirect ownership" as "the ability in fact to realize ownership rights in such entity using ownership that another person directly has in such legal entity."<sup>69</sup> This is roughly akin to the concept of "beneficial ownership" which is used in the Canadian Bank Act and many other banking or financial laws and literature around the world.<sup>70</sup>

On the other hand, the Serbian Banking Law does complicate things in another respect. For some reason, the drafters chose to use the

<sup>65</sup> See Stirewalt and Gegenheimer, *supra* note 61, at 566.

<sup>66</sup> EU Banking Directive, *supra* note 55, art. 4, ¶11.

<sup>67</sup> Such terminology is used in the German and Swiss banking acts. See "Gesetz über das Kreditwesen" § 1(9) (F.R.G.) [hereinafter German Banking Act], available at [http://www.bundesbank.de/bank/download/pdf/kwg\\_e.pdf](http://www.bundesbank.de/bank/download/pdf/kwg_e.pdf) (defining "qualifying participating interest"); Federal Law on Banks and Savings Banks, art. 3, para. 2 c bis (Switz.) [hereinafter Swiss Banking Act] (referring to a "qualified participation").

<sup>68</sup> See EU Banking Directive, *supra* note 55, art. 134, ¶ 1(a); EU Financial Conglomerates Directive, *supra* note 56, art. 5 ¶ 4.

<sup>69</sup> Serbian Banking Law, *supra* note 1, art. 2.

<sup>70</sup> See, e.g., Canadian Bank Act, R.S.C. ch. 46 § 2 (2006) (defining "beneficial ownership" as "includ[ing] ownership through one or more trustees, legal representatives, agents or other intermediaries.").

“participation” terminology in the licensing sections, which pertain to establishment of new banks,<sup>71</sup> but phrase other requirements in terms of ownership. Thus, Article 94 provides that “[n]o person may acquire direct or indirect ownership in the bank which provides 5% to 20%, over 20% to 33%, over 33% to 50% and over 50% of voting rights, without the prior consent granted by the National Bank of Serbia.”<sup>72</sup> These requirements generally track the EU’s progressive scale of supervisory scrutiny of ownership or influence over a bank.<sup>73</sup> Given the “indirect ownership” definition, which clearly is the equivalent of the “participation” definition, the intent is clear enough, yet the drafters chose to use the “ownership” phrasing in certain key places. To complicate things further, Section 1 of Chapter V of the Law is actually entitled “Participation in a Bank,” but some of the provisions refer to “participation” and some to “ownership.” While the two concepts are largely interchangeable, the law would be easier to follow if one phrasing was used consistently.

## 2. Criteria for Approval: “Fit and Proper” Persons

The new Banking Law improves considerably the criteria for approval of persons to become participants in banks. Previously, the only standard mentioned for receiving NBS approval was the proposed founder’s or acquirer’s credit rating.<sup>74</sup> However, much more than this is needed. The Basel Committee emphasizes that significant shareholders of banks must be “fit and proper” persons as well as financially stable.<sup>75</sup> The banking laws of Basel Committee countries, as well as a number of other countries that have

<sup>71</sup> See Serbian Banking Law, *supra* note 1, art. 15, ¶ 1(5) (requiring the submission of data on all persons expected to have a participation in a newly-licensed bank). The exact nature of this data is not specified, which leaves the NBS the flexibility to determine what information must be submitted. See *id.* at art. 15, ¶ 6 (providing that the NBS “may prescribe detailed requirements and manner of acquiring the preliminary approval.”).

<sup>72</sup> *Id.* at art. 94, ¶ 1.

<sup>73</sup> See EU Banking Directive, *supra* note 55, art. 19, ¶ 1.

<sup>74</sup> 1993 Banking Law, *supra* note 4, art. 8, art. 12.

<sup>75</sup> See BASEL COMMITTEE ON BANKING SUPERVISION, CORE PRINCIPLES METHODOLOGY 11 (October 2006), available at <http://www.bis.org/publ/bcbs130.htm> [hereinafter CORE PRINCIPLES METHODOLOGY]. The Core Principles Methodology is a set of guidelines to assist countries in assessing compliance with the Basel Committee’s *Core Principles for Effective Banking Supervision* [hereinafter Core Principles], which were originally published in 1997 and updated in October 2006. The Core Principles, which have become the *de facto* international standard for the sound prudential regulation and supervision of banks, are available at the website of the Basel Committee on Banking Supervision, <http://www.bis.org/publ/bcbs129.htm>.



patterned their banking laws after the Basel Committee's recommendations, reflect this emphasis.<sup>76</sup>

The new Serbian Banking Law expands the criteria considerably and now is much more aligned with international practice. Key persons in banks, such as members of the board of directors, executive board, and persons with "participations" in the bank, must have an "appropriate business reputation," which allows the NBS to make discretionary determinations about a person's business background.<sup>77</sup>

### **B. Risk Management**

To a much greater extent than the previous law, the new law emphasizes risk management in banks. The 1993 Banking Law mentioned risk only in scattered places, most of them in articles having to do with the capital adequacy ratio, mandatory reserves, deposit insurance, or various penalties.<sup>78</sup> Only one article in the 1993 law specifically mentioned the concept of risk management: a prospective bank's memorandum of association had to include the bank's proposals for bearing risks and covering losses.<sup>79</sup> Most of the items in the memorandum of association pertain to the basic structure and methods of organizing the bank; risk management techniques are more usually the subject of ongoing operation. In addition, the 1993 Banking Law required that any amendments to a bank's memorandum of

---

<sup>76</sup> See German Banking Act (2001), available at <http://www.iuscomp.org/gla/statutes/KWG.htm#III> ("trustworthiness"); Estonian Credit Institutions Act (1999), available at <http://www.legaltext.ee/text/en/X30042k9.htm> ("impeccable business reputation"). See also Netherlands Financial Supervisory Authority, Policy Rule on Integrity Testing (2005), available at <http://www.afm.nl/marktpartijen/default.aspx?DocumentId=2955>.

<sup>77</sup> Serbian Banking Law, *supra* note 1, art. 15, ¶ 6, art. 16, ¶¶ 2, 3, art. 71, ¶ 5, art. 72, ¶¶ 1, 2, 3 and 8, art. 75, ¶ 5, art. 94, ¶ 3, and art. 96.

<sup>78</sup> See, e.g., 1993 Banking Law, *supra* note 4, art. 26, ¶ 2(2) (referring to capital adequacy calculations based on risk-weighted assets), art. 27 (requiring that banks maintain the volume and structure of their risk-weighted investments within the ratios prescribed by the NBS), art. 31 (referring to risk-based deposit insurance premiums), art. 55 (requiring the formation of reserves to cover operating risks), art. 57e, ¶ 2 (3) (authorizing the NBS to issue a corrective decision to a bank requiring it to maintain capital of at least 8% of risk-weighted assets), art. 57f (authorizing the NBS Governor to place a bank under NBS administration if its capital fell below 4% of risk-weighted assets), and art. 78, ¶ 1(16) (imposing monetary penalties for failure to maintain capital at the prescribed ratio of risk-weighted assets).

<sup>79</sup> See *id.* at art.6, point 9.

association had to be approved by the NBS, which made it difficult for a bank to adapt its risk management practices to changing circumstances.<sup>80</sup>

The new law leaves no room for doubt that risk management is the name of the game. An application for preliminary approval to establish a new bank must include a description of the proposed procedures for risk management and internal controls,<sup>81</sup> and the application may be denied if the NBS is not satisfied as to their quality.<sup>82</sup> An entire section of the law is devoted to risk management.<sup>83</sup> Each bank is obligated to identify, measure and assess the risks to which it is exposed in its business activities, and to manage such risks.<sup>84</sup> In addition, each bank must form a special organizational unit, the competence of which includes risk management.<sup>85</sup> Risk management is tailored to the circumstances of the individual bank: the size and organizational structure of the bank, the volume of operations, and the types of activities.<sup>86</sup> Each bank is specifically required to adopt policies and procedures governing liquidity risk;<sup>87</sup> credit risk;<sup>88</sup> interest rate, foreign exchange and other market risks;<sup>89</sup> exposure of the bank to one person or a group of related persons;<sup>90</sup> risks relating to investments in other legal entities and in fixed assets;<sup>91</sup> country risk;<sup>92</sup> and operational risk.<sup>93</sup>

### *C. Bank Corporate Governance*

One of the principal areas in which the new law improves upon the previous situation is in the area of bank corporate governance. The law makes it clear that the ultimate responsibility for the sound and prudent management of a bank is on the board of directors, and specifies the role and functions of the board.<sup>94</sup> The law also mandates a suitable system of internal controls in each bank,<sup>95</sup> and requires an annual risk management report from each bank on

---

<sup>80</sup> See *id.* at art. 28, ¶ 1.

<sup>81</sup> Serbian Banking Law, *supra* note 1, art 15, ¶ 1, point 8.

<sup>82</sup> *Id.* at art 16.

<sup>83</sup> *Id.* at Ch. III, section 2.

<sup>84</sup> *Id.* at, art. 28, ¶ 1.

<sup>85</sup> *Id.* at §2.

<sup>86</sup> *Id.* at §3.

<sup>87</sup> *Id.* at arts. 29, 30.

<sup>88</sup> *Id.* at arts. 29, 31.

<sup>89</sup> *Id.* at arts. 29, 32.

<sup>90</sup> *Id.* at arts. 29, 33.

<sup>91</sup> *Id.* at arts. 29, 34.

<sup>92</sup> *Id.* at art. 29.

<sup>93</sup> *Id.* at arts. 29, 35.

<sup>94</sup> *Id.* at art. 73.

<sup>95</sup> *Id.* at art. 82.

the effectiveness of these items.<sup>96</sup> In a few areas, however, remnants of the old system remain.

### 1. Governance Structure

Under the previous law, the governance structure in banks was rather cumbersome. There were two non-executive boards in a bank: the "management board" and the "supervisory board."<sup>97</sup> Both of these boards were elected by the shareholders. These boards did not have the same connotation as in many Continental European countries, where the two-board structure is common. In a typical European country, especially German and German-influenced countries, there is a "supervisory board," which is elected by the shareholders (though it may include employee representatives as well), and it performs approximately the same function as the board of directors in the Anglo-American system.<sup>98</sup> The "management board" is elected by the supervisory board and consists of the full-time senior management of a company. A major difference between the European (or, perhaps more accurately, German) model and the Anglo-American model is that typically in the European/German model the supervisory board contains no full-time senior managers, whereas in the Anglo-American system the board of directors will often include at least some members of senior management (though usually less than a majority).<sup>99</sup>

In Serbia, the supervisory board is not simply a variation on the board of directors; it is a separate body elected by the shareholders, the purpose of which appears to be to "keep an eye" on the board of directors and management board, to make sure they are doing their jobs properly, and to make sure the financial and accounting functions are performed properly, etc. While the historical foundations of the supervisory board are not entirely clear, it seems to have originated in socialist times as a means of ensuring control by the state, and in particular ensuring that state-owned enterprises did not become too "entrepreneurial." Similar boards are still found in the banking and corporate laws of many former communist countries. Often this body is

---

<sup>96</sup> *Id.* at art. 87. This requirement is based on a similar provision in U.S. law. See 12 U.S.C. § 1831m(b).

<sup>97</sup> 1993 Banking Law, *supra* note 4.

<sup>98</sup> See generally Diane K. Denis and John J. McConnell, *International Corporate Governance* 7-8, European Corporate Governance Institute Finance Working Paper No. 05/2003 (January 2003); Theodor Baums, Professor, J.W. Goethe University; Fellow, European Corporate Governance Institute, Crafoord Lecture: Corporate Governance Systems in Europe: Differences and Tendencies of Convergence (August 1996); CORE PRINCIPLES METHODOLOGY, *supra* note 75 at 15, n.16.

<sup>99</sup> Denis and McConnell, *supra* note 98.

called the “revision commission” or something similar.<sup>100</sup> This board, or committee, combines certain functions normally found in an audit committee with those normally found in a board of directors. This concept is still contained in the Serbian Companies Law.<sup>101</sup>

---

<sup>100</sup> See, e.g., Law of Ukraine on Banks and Banking (2001), art. 44 (“revision commission”); (former) Law on Banks and Banking in the Kyrgyz Republic (1997) art. 24 (“revision commission”); Moldovan Banking Law, art. 20 (referring to an “audit committee” that nominally reports to the board of directors, but is in fact elected by the shareholders and the functions of which can be delegated to an outside audit firm other than the bank’s designated external auditor). See also Russian Law on Joint Stock Companies, art. 85 (referring to an “audit commission” elected by the general shareholders’ meeting). In Russia this body is often also called the “revision commission.” See Organization for Economic Cooperation and Development, *White Paper on Corporate Governance in Russia* 28, ¶ 147, April 24, 2002, available at [www.oecd.org](http://www.oecd.org).

<sup>101</sup> The Law on Business Companies requires that listed companies have either an audit committee, an internal auditor, or a supervisory board. Serbian Law on Business Companies, art. 332, ¶(1). A company must have a supervisory board if a law other than the Law on Business Companies requires that it have a supervisory board because of its activities. *Id.* at ¶(2). There is no such requirement for closed companies, but the company’s articles of association or by-laws may provide that the company will have an internal auditor or an audit committee. *Id.* at ¶(3). Under the Law on Business Companies, the supervisory board is appointed by the shareholders’ assembly. *Id.* at art. 333, ¶(2). A member of a supervisory board may not be a member of the board of directors, and all supervisory board members must be independent as defined in the Law on Business Companies. *Id.* at ¶(1). The supervisory board, audit committee, or internal auditor reports to the shareholders’ assembly on the following: 1) the accounting, reporting and financial practices of the company and its related companies; 2) the company’s compliance with legal and regulatory requirements; 3) the qualifications, independence and performance of the company’s independent auditor; and 4) contracts between the company and members of the board of directors and persons related to them. *Id.* at art. 335, ¶(1). They also review and discuss with the board of directors and the company’s outside auditor when appropriate, matters relating to 1) the selection, compensation and oversight of the work of the outside auditor; 2) the adequacy and completeness of the annual and other financial statements of the company and the basis for proposals for distribution of profit and other distributions to shareholders; 3) the adequacy and completeness of the company’s disclosure of financial and other information to the shareholders; 4) conformity of the organization and activities of the company with the corporate governance guidelines; 5) the adequacy of the company’s policies and procedures for legal compliance; and 6) procedures for handling any complaints from shareholders, governmental bodies or other persons concerning the foregoing. *Id.* at ¶(2). As is readily apparent, the functions of the supervisory board, audit committee or internal auditor under the Law on Business Companies are functions for which, under modern corporate governance principles, the board of directors is entirely responsible. Compare ORGANISATION FOR

The text of the previous law was somewhat confusing as to the respective functions of the two boards, and did not clearly differentiate their functions. For example, Article 44 of the 1993 law provided that the management board was the "controlling organ" of the bank.<sup>102</sup> However, Article 47 provided that the supervisory board "monitored and controlled" the activities of the bank's management board, manager, and employees.<sup>103</sup> Moreover, Article 48 assigned to the supervisory board the task of notifying the NBS about deficiencies discovered in the bank's operations, and suggesting to the bank's bodies ways of elimination of such deficiencies.<sup>104</sup> Thus, it was not clear from the text of the law which of the two boards was really the controlling body. In practice this led to confusion and lack of accountability, as it was not clear which body was ultimately responsible for the safe and sound operation of the bank.

Both Article 45 and Article 47 of the previous law contained provisions for the respective boards presenting reports and findings to the shareholders, but the law was not clear as to the difference between the two kinds of reports.<sup>105</sup> Thus, Article 45 provided that the board of directors scheduled sessions of the shareholders' meeting, prepared proposals for the shareholders, and implemented their decisions,<sup>106</sup> while Article 47 provided that the supervisory board notified the shareholders' meeting of its findings (apparently after considering decisions made by the bank's organs and auditors' reports), and could schedule a special shareholders' meeting to suggest ways to remedy deficiencies.<sup>107</sup> It was thus unclear which board was ultimately responsible for reporting to the shareholders and taking action to implement decisions to improve the bank's operations. Finally, some of the functions specified in Articles 47 and 48 for the supervisory board seemed better suited to an audit committee.<sup>108</sup>

The bottom line is that the board structure was considerably more complicated than it needed to be, and did not clearly delineate accountability and responsibility for sound and prudent bank management. The new law institutes a simpler and more streamlined approach, much more in line with modern corporate governance principles, which clearly sets out the structure

---

ECONOMIC COOPERATION AND DEVELOPMENT, PRINCIPLES OF CORPORATE GOVERNANCE (2004), Principle 59 [hereinafter OECG PRINCIPLES OF CORPORATE GOVERNANCE].

<sup>102</sup> 1993 Banking Law, *supra* note 4, at art. 44, para. 1.

<sup>103</sup> *Id.* at art. 47.

<sup>104</sup> *Id.* at art. 48.

<sup>105</sup> *Id.* at art. 45 and art. 47.

<sup>106</sup> *Id.* at art. 45.

<sup>107</sup> *Id.* at art. 47.

<sup>108</sup> See, e.g., 1993 Banking Law, *supra* note 4, at art. 47.3 (consideration of auditors' reports), and art. 48.1&3 (suggesting means of eliminating deficiencies).

and functions of the board of directors, senior management, and the audit committee.

One area in which the new law falls a bit short is shareholder rights. Under the new law, a bank's articles of association may not preclude direct exercising of voting rights of shareholders holding 1% or more of voting shares.<sup>109</sup> The implication is that a bank may preclude shareholders with less than 1% ownership from voting, which is contrary to the "one-share, one vote" principle.<sup>110</sup>

## 2. The Board of Directors and Audit Committee Under the New Law

The board of directors of a bank must consist of not less than five members, including the president of the board.<sup>111</sup> At least one-third of members of the board of directors of a bank must be persons independent of the bank, meaning that this person cannot hold any direct or indirect ownership in the bank or in a member of the bank's banking group.<sup>112</sup> Members of the board must have an appropriate business reputation and qualifications, which are prescribed by the NBS.<sup>113</sup> At least three members of the board must have the appropriate experience in the field of finance.<sup>114</sup> At least one member must be fluent in the Serbian language and have permanent residence in the Republic of Serbia.<sup>115</sup> The bank's board of directors meets when needed, and at least quarterly.<sup>116</sup>

These provisions clearly are a vast improvement over the previous law. Still, some areas are not entirely satisfactory.

The concept of board member independence is one upon which there is substantial agreement in mainstream corporate governance circles.<sup>117</sup> The problem with the Serbian Banking Law is that it takes the concept to an extreme. Any direct or indirect share ownership in the bank precludes a person from being considered independent – and this is only a minimum

---

<sup>109</sup> Serbian Banking Law, *supra* note 1, at art. 65.

<sup>110</sup> See OECD PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 101, at 41 (noting that all shareholders within a class should be treated equally, though not specifically taking a position on the "one share, one vote" principle).

<sup>111</sup> Serbian Banking Law, *supra* note 1, at art. 71(1).

<sup>112</sup> *Id.* at art. 71, ¶¶2, 3. See also *id.* at art. 2 (defining "banking group").

<sup>113</sup> *Id.* at art. 71, ¶5.

<sup>114</sup> *Id.* at art. 71, ¶6.

<sup>115</sup> *Id.* at art. 71, ¶7.

<sup>116</sup> *Id.* at art. 74, ¶1.

<sup>117</sup> See, e.g., OECD, PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 101, at 52; NYSE Listed Co. Manual § 303A.01 (Nov. 4 2003).

requirement.<sup>118</sup> In fact, there is no requirement that *any* of the board members own any shares. It is thus quite possible that the entire board could be comprised of persons with absolutely no connection to the bank except that they have been “hired” by the shareholders. This could easily lead to a situation where the board is comprised of “directors who do not direct” - people who serve on the board for “prestige,” or as a convenient means of supplementing their income, but do not actually do anything. This is a serious problem in transition economies, and one that the Serbian Banking Law, unfortunately, helps to perpetuate.

It is now widely recognized that having bank directors with significant amounts of their own money at risk is a good thing. Such owners want a financial return from the bank that compensates them for the risk of their equity position. Because they have their own investment at risk, they have a strong incentive to watch senior management carefully in order to ensure that the managers are acting in a way that will enhance the bank's financial performance. By contrast, where members serve on a board for “prestige” reasons and, “do not have serious amounts of their own money at risk, they tend not to look over management's shoulder the same way business investors do.”<sup>119</sup> Recognizing this principle, some countries, including the United States, require directors to have a prescribed amount of ownership in their banks, either directly or through the bank's parent holding company.<sup>120</sup>

At the same time, many countries require that a certain percentage of a board's membership be comprised of “independent,” or outside directors, and prescribe an ownership threshold above which a director is not considered “independent.” Often these thresholds are rather low (5% or 10% is fairly typical),<sup>121</sup> but few, if any, advanced countries completely preclude a person

---

<sup>118</sup> Serbian Banking Law, *supra* note 1, art. 71, para. 3.

<sup>119</sup> See Robert Peck Christen & Richard Rosenberg, *The Rush to Regulate: Legal Frameworks for Microfinance*, CGAP Occasional Paper, No. 4, April 2000, at 6, available at [http://www.cgap.org/docs/OccasionalPaper\\_04.pdf](http://www.cgap.org/docs/OccasionalPaper_04.pdf). See also United Nations Conference on Trade and Development, 2003, *Selected Issues in Corporate Governance: Regional and Country Experiences* UNCTAD /ITE/TEB/2003/3 at 7.

<sup>120</sup> U.S. National Bank Act, 12 U.S.C.A. § 72 (2000). But see Canadian Bank Act, *supra* note 70, § 161 (no shareholding requirement for directors of banks); § 751 (same principle for directors of bank holding companies).

<sup>121</sup> For example, §10A of the Securities and Exchange Act of 1934, as amended by the Sarbanes-Oxley Act of 2002, requires that members of the audit committee of a listed company be independent, meaning, *inter alia*, that the director cannot be an “affiliated person” of the company. 15 U.S.C.A. § 78j-1(2002). An “affiliated person” under section 3 of the Exchange Act, which incorporates section 2(a)(3) of the Investment Company Act of 1940, uses a 5% threshold. *Id.* at § 78c. In Canada, no more than two thirds of the members of a bank's board of directors may be persons

from being considered independent simply because he or she owns a minuscule amount of company stock. Even the Serbian Law on Business Companies uses a ten percent threshold.<sup>122</sup>

Another issue concerns the frequency of board meetings. The requirement for quarterly board meetings<sup>123</sup> is not unreasonable. A number of mainstream countries have such a requirement.<sup>124</sup> Still, there is a legitimate question as to whether quarterly meetings are really sufficient. Particularly in a transition economy, where a strong corporate governance culture has yet to take hold, there is a real possibility that the legal minimum will become the *de facto* maximum – in other words, that bank boards may meet quarterly more out of a need to satisfy the legal requirement for a specified number of meetings than genuine concern for good management. In a number of these banks, monthly meetings may in fact be necessary. For this reason, it might be more appropriate to require monthly, rather than quarterly meetings.<sup>125</sup>

The Serbian Banking Law borrows a provision from the Canadian Bank Act that has the potential to contribute toward a strong bank corporate governance culture; each bank's annual report to the NBS must indicate the total number of meetings the bank's board of directors held for the previous year and the location where they were held.<sup>126</sup> Unfortunately, this provision is incomplete; the idea is not simply to notify the NBS as to how many meetings were held and where, but also which directors actually attended those meetings, along with similar information on meetings of board committees.<sup>127</sup>

---

"affiliated with the bank." Canadian Bank Act, *supra* note 70, at § 163(1). An exception is allowed for banks that are wholly-owned subsidiaries of Canadian financial institutions. *Id.* at § 163(2). A person is considered to be "affiliated with the bank" if has a "significant interest" in a class of shares of the bank (defined as beneficial ownership exceeding 10%). *See id.* at § 8(1); Canadian Office of the Superintendent of Financial Institutions Regulation 92-325, Affiliated Persons (Banks) Regulations; Circumstances Under Which a Natural Person is Affiliated; SOR/92-325, § 3 (Can) available at <http://laws.justice.gc.ca/en/b-1.01/sor-92-325/text.html>. *See generally* INTERNATIONAL FINANCE CORPORATION, RUSSIA CORPORATE GOVERNANCE MANUAL 200 n.142 (2004), available at [www.ita.doc.gov/goodgovernance/adobe/CGMEnPart\\_6/a18.pdf](http://www.ita.doc.gov/goodgovernance/adobe/CGMEnPart_6/a18.pdf).

<sup>122</sup> Serbian Law on Business Companies, *supra* note 101, art. 313(2), (5).

<sup>123</sup> Serbian Banking Law, *supra* note 1, art. 74, para. 1.

<sup>124</sup> *See* Canadian Bank Act, *supra* note 70, § 180(1); Estonian Credit Institutions Act, *supra* note 76 § 54(1); Austrian Code of Corporate Governance (2002), ¶ 36, available at [http://www.ecgi.org/codes/documents/cg\\_code\\_en.pdf](http://www.ecgi.org/codes/documents/cg_code_en.pdf).

<sup>125</sup> Indeed, the audit committee is required to meet monthly. *See* Serbian Banking Law, *supra* note 1, art. 74, ¶ 1.

<sup>126</sup> *Id.* at art. 74, ¶ 6.

<sup>127</sup> Compare Canadian Bank Act, *supra* note 70, § 186(2). *See also id.* at art. 776(2) (bank holding companies). Note, however, that the Canadian Act requires such



In this way, the NBS would receive a clear idea as to which directors are taking their duties seriously.

Another area in which the vestiges of the old system have not been completely eliminated involves the audit committee. The new law eliminates the supervisory board and contains a requirement that each bank have an audit committee.<sup>128</sup> Article 80 is patterned after Section 247 of the Canadian Bank Act, which in this author's opinion is the best legislative provision on the structure and functions of audit committees in banks. Nevertheless, the Serbian law is not entirely satisfactory.

The audit committee consists of at least three members, at least two of which are members of the bank's board of directors who have the appropriate experience in the field of finance.<sup>129</sup> This is positive. However, at least one member of the committee must be a person who is "independent" of the bank, meaning that he or she cannot have any direct or indirect ownership in the bank and/or in any member of the bank's banking group – let alone be a director of the bank.<sup>130</sup> The new law thus does not entirely rid the legal structure of the remaining relics of the old supervisory board – there is still a mandatory outside presence on the audit committee, which logically should be entirely the domain of the board of directors.

Members of the audit committee cannot be persons related to the bank, except by virtue of their membership in the board of directors of the bank or the management and/or supervisory bodies of a component entity of the same banking group. The committee assists the bank's board of directors in supervising activities of the executive board and employees of the bank. In particular, the committee must:

- (1) Analyze annual and other financial statements of a bank, which are submitted for review and adoption to the bank's board of directors;

---

information to be furnished to the bank or holding company's shareholders in connection with the annual meeting. In this author's view, it would also be wise to require that this information be furnished to the bank supervisory authority. "Sunlight is said to be the best of disinfectants; electric light the most efficient policeman." See LOUIS BRANDEIS, *OTHER PEOPLE'S MONEY, AND HOW BANKERS USE IT* 92 (1933).

<sup>128</sup> For convenience, this article refers to this committee as the "audit committee." In the text of the Serbian Banking Law, Article 80 refers to the committee as the "Audit Committee (Committee for Monitoring the Business Activities of the Bank)" and then proceeds to repeat the longer designation – rather than use the shorter version – every time it refers to the committee.

<sup>129</sup> Serbian Banking Law, *supra* note 1, art. 80, ¶ 1.

<sup>130</sup> *Id.* at ¶ 2. See *id.* at art. 71.

- (2) Analyze and adopt draft policies and procedures of a bank regarding risk management and the system of internal controls, which are submitted for review and adoption to the bank's board of directors;
- (3) Analyze and supervise implementation and adequate enforcement of adopted policies and procedures for risk management and the implementation of the system of internal controls;
- (4) At least once per month report to the board of directors on its activities and detected irregularities, and give suggestions for the manner in which the detected irregularities will be eliminated, and/or the manner of improvement of policies and procedures for risk management and the implementation of the system of internal controls;
- (5) Review investments and activities of the bank, upon proposal of the board of directors or executive board or external auditor of the bank;
- (6) Give proposal regarding the external auditor of a bank to the bank's board of directors and assembly;
- (7) Review annual audits of the financial statements of the bank with the bank's external auditor;
- (8) Suggest to the board of directors that certain issues pertaining to the bank's external and internal audit be included into the agenda for the assembly meeting; [and]
- (9) Render [a] rulebook of its activities.<sup>131</sup>

Should the committee determine that the bank's operations are in breach of the law, other regulations, articles of association or other enactment of the bank, or if that can be concluded from the auditor's report, and/or if it establishes other irregularities in the bank's business activities, the committee must suggest to the bank's board of directors ways to eliminate the detected irregularities.<sup>132</sup> It may also call an extraordinary meeting of the bank's

---

<sup>131</sup> *Id.* at art. 80, ¶ 5.

<sup>132</sup> *Id.* at ¶ 6.

shareholders' assembly if it determines irregularities that may have severe consequences regarding business activities of the bank.<sup>133</sup>

The committee meets at least once a month, and at least quarterly at the bank's head office.<sup>134</sup> This is an effective means of ensuring that the committee members, who in Serbian banks are likely to be from other countries due to the large amount of foreign ownership in the Serbian banking sector, maintain a reasonable degree of contact with their banks and management.

### 3. *Bank Management*

The previous Banking Law provided for one manager.<sup>135</sup> However, both the EU and the Basel Committee emphasize that even in very small banks, key management decisions should be made by more than one person (the "four eyes principle").<sup>136</sup> The manager was also appointed by, and reported to, the shareholders' meeting, which was cumbersome.<sup>137</sup> In the event of a manager's departure from office, it was necessary to hold a special meeting of the shareholders to appoint a new manager. This provision also meant that the manager was appointed by a body with no business experience, or any fiduciary obligation to act in the best interest of the bank. There were no real "fit and proper" requirements for bank managers; the only thing resembling a fitness test was the requirement that the prospective manager must not have been convicted of a crime against the economy or involving a breach of his official duty.<sup>138</sup> The previous law also contained only a short and perfunctory list of duties of the manager. The manager was authorized to:

- (1) Represent and act on behalf of the bank;
- (2) Execute the decisions of the bank's assembly, management board and supervisory board;
- (3) Organize the activity and manage the operations of the bank;

---

<sup>133</sup> *Id.*

<sup>134</sup> *Id.* at ¶ 7. Note that while the audit committee must meet monthly, the board of directors is obliged to meet only quarterly. See *id.* at art. 1.

<sup>135</sup> 1993 Banking Law, *supra* note 4, at art. 49.

<sup>136</sup> EU Banking Directive, *supra* note 55, at art. 11, ¶ 1; BASEL COMMITTEE. CORE PRINCIPLES METHODOLOGY, *supra* note 75, at 28.

<sup>137</sup> 1993 Banking Law, *supra* note 4, at art. 49.

<sup>138</sup> *Id.*

(4) Decide on all the matters that are not within the terms of reference of the bank's assembly, management board and supervisory board.<sup>139</sup>

The new law requires an executive board in each bank and is much more detailed on the duties and responsibilities of management. Under the new law, a bank's executive board must have at least two members, following the EU requirement.<sup>140</sup> All members of the management team must have a good business reputation.<sup>141</sup> Management is required to:

- (1) Carry out the decisions of the bank's assembly and board of directors;
- (2) Ensure legal compliance of the bank's activities;
- (3) Make decisions regarding placements and indebtedness of the bank up to the amount determined by the bank's board of directors;
- (4) Make decisions on any increase of exposure of the bank to a person related to the bank and inform the bank's board of directors of that;
- (5) Implement the business strategy of the bank;
- (6) Identify and measure risks the bank is exposed to in its business activities, and implement principles of risk management approved by the bank's board of directors;
- (7) Render the organizational structure of the bank that is suitable for the bank's strategy;
- (8) Implement procedures of supervision of the bank's activities, regularly evaluate their quality and improve

---

<sup>139</sup> *Id.* at art. 50.

<sup>140</sup> Serbian Banking Law, *supra* note 1, at art. 75, ¶1.

<sup>141</sup> Actually, the law arrives at this requirement in a rather convoluted fashion: Article 75 states that members of the board of directors must have a good business reputation and appropriate qualifications as prescribed by the NBS. Serbian Banking Law, *supra* note 1, at art. 75, ¶5. Per its title, however, that article is about the executive board, not the board of directors. *Id.* Query, then, what the requirement as to board of director membership is doing in article 75. Executive board members are subject to the same procedural requirements as to their appointment as members of the board of directors – in both cases NBS approval is necessary. *Id.* at art. 75, ¶7; art. 72, ¶1. In either case, an appropriate business reputation is necessary. *Id.*

them, if necessary, in accordance with the business policy of the bank;

- (9) Ensure that all employees of the bank are aware of the regulations and other enactments of the bank regulating their business duties;
- (10) Ensure safety and regular monitoring of the bank's information technology systems;
- (11) Ensure safety and regular monitoring of systems regarding treasury activities;
- (12) Inform the board of directors of all activities which are not in compliance with regulations and other enactments of the bank;
- (13) Present an overview of business activities, balance sheet and income statement of the bank to the bank's board of directors at least once during each business quarter;
- (14) Promptly inform the bank's board of directors and the National Bank of Serbia of any deterioration of the financial situation of the bank, or the existence of the danger of such deterioration, as well as other facts that may significantly affect the financial situation of the bank;
- (15) Make decisions regarding any issues that are not in competence of the bank's assembly and board of directors of the bank.<sup>142</sup>

#### ***4. Fiduciary Duties of Managers and Board Members***

The 1993 law contained an extremely skeletal statement of the fiduciary duties of bank directors and managers. Article 41(a) provided that members of the management board and supervisory board of a bank, as well as the managing director of the bank, had to indemnify the bank in the event that they did any of the following acts in contravention of the Banking Law:

- returned investments to the shareholders;

---

<sup>142</sup> *Id.* at art. 76, para. 2. These provisions are based on the parallel sections of the Estonian Credit Institutions Act. See Estonian Credit Institutions Act, *supra* note 76, art. 55, ¶2.

- acquired their own shares;
- distributed [the bank's] profits; or
- decreased the bank's share capital.<sup>143</sup>

Article 41(b) provided that these persons were liable for damages arising in cases determined by the Banking Law and the bank's articles of association.<sup>144</sup>

The new law does not contain a specific fiduciary duty standard, but incorporates the standard from the new Law on Business Companies.<sup>145</sup> That law contains duties of care and loyalty that are, at least on paper, in line with modern corporate governance principles.<sup>146</sup> As a practical matter, however, much work remains to be done in this area. The World Bank and the IMF, in their recent Financial Sector Assessment Report, found that corporate governance practices were still poor, especially in domestic banks.<sup>147</sup>

### 5. *Transactions with Related Persons*

The 1993 law prohibited banks from extending credits to their shareholders until at least one year after the bank has been entered in the court register.<sup>148</sup> There was also a limitation of 5% of a bank's capital on credit to: any bank shareholder, persons connected to shareholders by ownership and controlling rights or member of the bank's governing bodies.<sup>149</sup> These provisions were clearly desirable, but more was necessary. Banks were permitted to engage in a number of kinds of activities,<sup>150</sup> and it is important that bank insiders not receive preferential treatment.

In addition, the "ownership or controlling rights" phrasing was problematic. This required some degree of share ownership or a formal contractual agreement on the management of an entity before an arrangement

<sup>143</sup> 1993 Banking Law, *supra* note 4, art. 41(a).

<sup>144</sup> *Id.* at art. 41(b).

<sup>145</sup> Serbian Banking Law, *supra* note 1, art. 3.

<sup>146</sup> Law on Business Companies, *supra* note 101, art. 32 (duty of care and business judgment rule), art. 33 (duty of loyalty).

<sup>147</sup> See World Bank, Financial Sector Assessment Program, Serbia ¶40 (November 2005), available at [wbln0018.worldbank.org/FPS/fsapcountrydb.nsf/\(attachmentwebFSA\)/SERBIA\\_FSAweb.pdf/\\$FILE/SERBIA\\_FSAweb.pdf](http://wbln0018.worldbank.org/FPS/fsapcountrydb.nsf/(attachmentwebFSA)/SERBIA_FSAweb.pdf/$FILE/SERBIA_FSAweb.pdf).

<sup>148</sup> 1993 Banking Law, *supra* note 4, art. 21(a).

<sup>149</sup> *Id.* at art. 26.

<sup>150</sup> *Id.* at arts. 21, 22.

fell within the ambit of Article 26. However, as noted above, it is quite possible, in practice, for a person to exert considerable influence over an entity even in the absence of formal share ownership or contractual arrangements.<sup>151</sup>

The new law puts considerably more teeth into these provisions. Article 37 provides that banks in their "business activities" may not approve more favorable conditions to a person related to the bank than the conditions approved to other persons not related to that bank.<sup>152</sup> Persons related to a bank include:

- (1) Members of the same banking group as the bank;
- (2) Members of the board of directors and executive board of the bank, members of management and governing bodies of a member of the same banking group in which the bank is, bank employees, as well as family members of these persons;
- (3) Persons with a participation in the bank and in entities which are the members of the same banking group in which the bank is, as well as family members (as defined in the law which governs business companies) of these persons;
- (4) Legal entities in which persons specified in items 2 and 3 of this paragraph hold controlling participation.<sup>153</sup>

A bank may conclude a transaction with a related person after being granted the written approval of the bank's board of directors.<sup>154</sup> This approval is not required in case of:

- (1) Placing deposits of related persons;
- (2) Granting credit collateralized by a linked deposit of a related person;
- (3) Granting credit collateralized by debt securities of the Republic of Serbia or the National Bank of Serbia, and/or debt securities of persons ranked by recognized

---

<sup>151</sup> See discussion *supra* note 61 and accompanying texts.

<sup>152</sup> Serbian Banking Law, *supra* note 1, art. 37.

<sup>153</sup> *Id.* at art. 2.

<sup>154</sup> *Id.* at art. 38, ¶ 1.

international agencies whose rating is not lower than "A".<sup>155</sup>

Members of a bank's board of directors are not permitted to participate in the consideration or approval of any legal transaction between themselves and the bank, between themselves and any member of their family, and between the bank and a legal entity in which they or any member of their family participates in management or governance, or in which they have a significant or controlling participation.<sup>156</sup> A bank also may not approve credits to its shareholders until one year following the day when the bank commenced its business activities.<sup>157</sup> Transactions concluded in breach of these conditions are deemed null and void.<sup>158</sup>

#### *D. Consolidated Supervision*

One of the new law's major accomplishments is the adoption of comprehensive provisions on consolidated supervision of "banking groups." This feature was totally absent from the 1993 law, yet it is critical to Serbia's hopes to join the EU. Consolidated supervision is a major part of the EU's banking and financial supervisory framework. Its principles are reflected mainly in two directives: the Banking Directive<sup>159</sup> and the Financial Conglomerates Directive.<sup>160</sup> Apart from the legal requirements that EU member states implement consolidated supervision, it is also vital from a practical standpoint. Two of the Basel Core Principles (24 and 25) address consolidated supervision directly.<sup>161</sup> But compliance with these two principles has a ripple effect: failure to comply with Core Principles 24 and 25 throws a country into non-compliance with many of the other Core Principles. It is quite clear that a country cannot be considered to be in overall compliance with the Core Principles unless it practices effective consolidated supervision.<sup>162</sup>

---

<sup>155</sup> *Id.* at ¶ 3.

<sup>156</sup> *Id.* at ¶ 4.

<sup>157</sup> *Id.* at art. 39.

<sup>158</sup> *Id.* at art. 40.

<sup>159</sup> See EU Banking Directive, *supra* note 55, especially arts. 124-141.

<sup>160</sup> See EU Financial Conglomerates Directive, *supra* note 56.

<sup>161</sup> BASEL CORE PRINCIPLES, *supra* note 75, Principles 24, 25. Principle 24 deals generally with consolidated supervision, while Principle 25 specifically addresses the cross-border aspects of this issue.

<sup>162</sup> See Stirewalt and Gegenheimer, *supra* note 61, at 546, n. 37. Other Core Principles that are affected by the extent of a country's application of consolidated supervision include Principle 3 (licensing); Principle 4 (transfers of significant ownership); Principle 5 (major acquisitions by banks); Principle 6 (capital adequacy);



## 1. The Importance of Consolidated Supervision

All banks are subject to financial risks, which emanate from activities that they directly undertake. Traditional banking risks include credit risk, liquidity risk, interest rate risk, and foreign exchange risk. But special risks, which are not as easily measured, also become applicable if the bank is part of a “group” of companies. Specific risks that apply in the banking group context include the following:

- *Contagion* - the risk that financial difficulties in another company in the group might “infect” the bank itself. Normally this arises because the bank’s depositors assume that financial problems of the other company could mean that the financial stability of the bank is also in jeopardy. This perception can precipitate substantial rapid withdrawals of deposits, resulting in a liquidity deficiency, and, if the problem escalates, a major “run” on deposits, which can even spread to other banks.
- *Group Transparency* – the possibility that controlling persons of a group might deliberately choose a complex structure in order to obscure the group’s true ownership, control, or operations, and thereby avoid effective regulation and supervision of the bank. In this scenario, financial fraud and insider abuse are high possibilities.
- *Quality of Management* – the risk that the owners and managers of a non-bank parent company might establish policies for the group that is detrimental to the bank or banks in the group. This can come about because the parent company’s owners or management might have business objectives other than prudent management of the bank, or lack a good understanding of the banking business and its regulatory requirements. In these circumstances, group/parent management might override or direct bank decisions, so that bank management loses some autonomy, or cannot exercise effective control over the bank’s lending or investment decisions. In the worst-case scenario, the managers or controlling participants of the group might use the bank

---

Principle 10 (large exposures); Principle 11 (exposures to related parties); Principle 21 (receipt of prudential reports on a solo and consolidated basis); Principle 22 (accounting and disclosure); and Principle 23 (corrective and remedial powers).

as a cheap funding source for the other group members, with insufficient regard for the safe operation of the bank. As with the previous point, in this scenario insider abuse and bank failure are high possibilities.

- *Access to Information* – the possibility that non-bank parent companies of banks, or non-bank subordinated companies of those parent companies, might be unwilling or unable to supply information to the bank for onward transmission to the bank regulator. This can be a particular problem in the case of foreign parents or subsidiaries.
- *Group Exposures to Third Parties* – the possibility that the bank could be adversely impacted due to excessive loans to, or investments in, other entities by the group or its non-bank members. Although it usually is not feasible to apply to such wider groups the same kinds of lending or investment limitations that apply to banks, all such groups should have their own limitations, policies and procedures for monitoring loans and investments.
- *Moral Hazard* – the risk that related companies of a bank might take excessive risks in the belief that the bank regulator or deposit insurer will provide them support in order to avoid a “contagion” effect on the related bank.<sup>163</sup>

Because of the dangers that these risks can pose to a bank, financial sector regulatory authorities must be aware of the structure of, and risks inherent in, any group of companies that includes a bank. Specifically, the regulator needs to be aware of the ownership structure, corporate governance standards, internal controls and risk management systems that the group uses to carry out its activities. The regulator also needs to review and assess the group’s controls on intra-group transactions and have continuing knowledge of aggregated large risk exposures within the group. The regulator further needs to assess the adequacy of capital on a consolidated basis to prevent a single financial entity within the group from showing an adequate capital position by virtue of accounting “gimmicks.” In order to accomplish these tasks the regulator must have two critical legal authorities:

---

<sup>163</sup> RONALD MACDONALD, CONSOLIDATED SUPERVISION OF BANKS, BANK OF ENGLAND HANDBOOKS IN CENTRAL BANKING NO. 5 10-15 (ed. Simon Gray 1998).

- (1) the authority to obtain reliable information about all of the entities in the group; and
- (2) the authority to take effective corrective actions, or cause other financial sector supervisors to do so, when activities or conditions of these affiliated persons may be detrimental to the financial stability of the bank(s) within the group.<sup>164</sup>

In bank supervisory parlance, there are three basic kinds of groups:

- (1) the bank and its downstream affiliates, sometimes called a *simple banking group*, or just a *banking group*;<sup>165</sup>
- (2) a *financial conglomerate*, a group of companies that engage in a range of different financial activities that have been traditionally kept separate (typically defined as banking, underwriting and trading in securities, and insurance);<sup>166</sup>
- (3) a *mixed-activity group*, which contains commercial and industrial companies as well as one or more banks.<sup>167</sup>

---

<sup>164</sup> BASEL COMMITTEE, CORE PRINCIPLES METHODOLOGY, *supra* note 75, at 38, Principle 23, Additional Criteria, points 2 and 3.

<sup>165</sup> See MACDONALD, *supra* note 163, at 9-10. In some cases, the group might be headed by a holding company, but the principal activity of the group is banking. *See id.* Traditionally, the Basel Committee considered a "banking group" to be only a bank and its banking or financial subsidiaries. *See* BASEL COMMITTEE, INTERNATIONAL CONVERGENCE OF CAPITAL MEASUREMENT AND CAPITAL STANDARDS (July 1988) [Basel I] 3, ¶ 10, and 7, ¶ 24. More recently, the Committee has included certain holding companies in the banking group structure. *See* BASEL COMMITTEE, INTERNATIONAL CONVERGENCE OF CAPITAL MEASUREMENT AND CAPITAL STANDARDS: A REVISED FRAMEWORK (June 2004) [Basel II] 7, ¶ 21 (defining a "banking group" as a group of companies that engages predominantly in banking activities, including the holding company). The holding company of the banking group might itself have a parent company, but that parent company would not be considered part of the banking group if its activities are broader than banking. *See id.* at n. 4.

<sup>166</sup> See MACDONALD, *supra* note 163, at 10; George A. Walker, *Conglomerate Law and International Financial Market Supervision*, 17 ANN. REV. BANKING L. 287 (1998); George A. Walker, *The Law of Financial Conglomerates: The Next Generation*, 30 INT'L LAW. 57.

<sup>167</sup> See MACDONALD, *supra* note 163, at 9-10; *See also* EU Banking Directive, *supra* note 55, art. 4 ¶ 20 (defining "mixed-activity holding company").

## 2. Consolidated Supervision and the New Serbian Banking Law

The new Serbian Banking Law represents a vast improvement over the previous law in this area. The law specifically defines a “banking group,” as a group of financial sector persons that includes at least one bank, and subjects such groups to special rules.<sup>168</sup>

Under the new law, a “group” of companies consists of the ultimate parent company of a legal entity, its subordinated companies and associated companies of the subsidiaries of the legal entity.<sup>169</sup> A parent company of a legal entity means a legal entity that holds controlling participation in such entity.<sup>170</sup> The ultimate parent company of a group is the legal entity in which no other legal entity holds a controlling participation.<sup>171</sup> A subordinated company of a legal entity means a subsidiary or an associated company of such entity.<sup>172</sup> A subsidiary of a legal entity means a company in which such entity holds controlling participation.<sup>173</sup> An associated company of a legal entity means a company in which such entity holds significant participation.<sup>174</sup> A banking group means a group of companies which consists exclusively of financial sector persons, and which includes at least one bank being the ultimate parent company or a subsidiary.<sup>175</sup> A bank holding company is the ultimate parent company in a banking group other than a bank.<sup>176</sup>

Banking groups are subject to special rules.<sup>177</sup> One of the most important of these relates to group transparency. The structure of a banking group must be sufficiently transparent to allow the NBS to determine:

- (1) The ultimate parent company of the banking group and persons who hold controlling or significant participation in that company;
- (2) Location and types of business activities conducted within the banking group;

---

<sup>168</sup> Serbian Banking Law, *supra* note 1, art. 2,

<sup>169</sup> *Id.*

<sup>170</sup> *Id.*

<sup>171</sup> *Id.*

<sup>172</sup> *Id.*

<sup>173</sup> *Id.*

<sup>174</sup> *Id.* This definition is the equivalent of the EU’s “participation” definition. See EU Banking Directive, *supra* note 55, art. 4, ¶ 10.

<sup>175</sup> Serbian Banking Law, *supra* note 1, art. 2.

<sup>176</sup> *Id.*

<sup>177</sup> *Id.* at ch. V, part 4.

- (3) The financial situation and business results of the banking group and its members;
- (4) Types and levels of risks that the banking group and its members are exposed to;
- (5) The manner in which risk management is organized and implemented at the banking group level; and
- (6) The business, financial and other relationships between members of the banking group.<sup>178</sup>

The organizational structure of a banking group must be such as to enable adequate internal and external audits, as well as not to impede the National Bank of Serbia's ability to perform its supervisory duties.<sup>179</sup>

The ultimate parent company of each banking group must prepare and submit consolidated financial statements to the NBS.<sup>180</sup> Both the bank and the ultimate parent company of the group are responsible for all meeting this requirement.<sup>181</sup>

Provisions of the law on capital adequacy, large exposures, investments in other legal entities and fixed assets, and limitations on open net currency position apply to banking groups on a consolidated basis.<sup>182</sup> The NBS may require the bank in a banking group to hold additional capital or to prescribe a capital adequacy ratio for the bank higher than the otherwise-prescribed level, if it determines that the level of the capital of the banking group jeopardizes the stable business activities of the bank.<sup>183</sup> Each banking group is also obliged to provide procedures for risk management and procedures for internal audit and internal control that correspond to the group's activities, as well as regular monitoring and updating of those procedures.<sup>184</sup> Both the bank and the ultimate parent company of a banking

---

<sup>178</sup> *Id.* at art 123, ¶1. The model for this provision is the Australian Prudential Regulatory Authority (APRA) *Policy Framework for the Prudential Supervision of Conglomerate Groups Containing Authorised Deposit-Taking Institutions* (Policy Information Paper, April 2000), available at <http://www.apra.gov.au> [hereinafter APRA Conglomerate Policy].

<sup>179</sup> Serbian Banking Law, *supra* note 1, art. 123, ¶2.

<sup>180</sup> *Id.* at art. 126, ¶ 1.

<sup>181</sup> *Id.* at, ¶ 2.

<sup>182</sup> *Id.* at, art. 127, ¶ 1.

<sup>183</sup> *Id.* at ¶ 2.

<sup>184</sup> *Id.* at ¶ 3. *Cf.* APRA Conglomerate Policy, *supra* note 178, at 9, ¶ 34. *See also* EU Financial Conglomerates Directive, *supra* note 56, art. 9 (requiring risk management and internal controls at the conglomerate level); German Banking Act,

group are responsible for determining and submitting the referenced data to the NBS.<sup>185</sup>

The law also authorizes the NBS to take corrective measures against any member of a banking group in case of violations or practices endangering the bank in the group.<sup>186</sup>

A bank may establish or acquire a subordinated company only with the consent of the NBS.<sup>187</sup> Only financial sector persons may be subordinated companies of banks.<sup>188</sup> The NBS is authorized to prescribe detailed requirements and the manner of granting for such consent.<sup>189</sup> A bank holding company may not establish or acquire direct or indirect ownership in a subordinated company if such acquisition would have a negative impact on business activities of the bank in which the bank holding company holds controlling participation.<sup>190</sup> A bank holding company must inform the NBS of any such ownership in a subordinated company within fifteen days after the date of the acquisition.<sup>191</sup> Should the NBS establish that such an acquisition may have negative consequences for the bank within the banking group, it can take any enforcement measures prescribed by the Banking Law.<sup>192</sup>

While the new law clearly marks an improvement on the old regime, it is only partially effective at giving the NBS the tools to perform effective consolidated supervision. The problem is that the consolidated supervision provisions are only applicable to “banking groups,” which by definition

---

*supra* note 67, § 25a(1); Croatian Banking Law, art. 93, available at <http://www.lexadin.nl/wlg/legis/nofr/eur/lxwecro.htm#Banking%20law> (last visited Dec. 4, 2006); Estonian Credit Institutions Act, *supra* note 76, § 82(1), (2).

<sup>185</sup> Serbian Banking Law, *supra* note 1, art. 127, ¶ 4.

<sup>186</sup> *Id.* at art. 128. Compare 12 U.S.C. § 1818(b)(3) (2002) (stating that enforcement measures apply to U.S. bank holding companies and their non-bank subsidiaries in the same manner as they apply to banks) with Canadian Bank Act, *supra* note 70, § 960 (authorizing the Superintendent to issue directions of compliance against bank holding companies and their affiliates); German Banking Act, *supra* note 67, § 6(3) (authorizing the Federal Financial Supervisory Authority (BAFin) to issue corrective orders to financial holding companies and their managers); EU Banking Directive, *supra* note 55, arts. 21, ¶2, 142; EU Financial Conglomerates Directive, *supra* note 56, art. 16.

<sup>187</sup> Serbian Banking Law, *supra* note 1, art. 124, ¶ 1.

<sup>188</sup> *Id.* at ¶ 2.

<sup>189</sup> *Id.* at ¶ 3.

<sup>190</sup> *Id.* at art. 125, ¶ 1.

<sup>191</sup> *Id.* at ¶ 2.

<sup>192</sup> *Id.* at ¶ 3.

include only financial sector persons.<sup>193</sup> Mixed-activity groups – groups consisting of commercial and industrial companies in addition to banks – are permitted, since any type of legal entity is allowed to own a bank, but such groups are not subject to any of the requirements of transparency, group-wide risk management or internal controls that are vital to an effective consolidated supervision regime. As a result, the law's requirements in this area are easy to evade: all a controlling shareholder has to do is create a non-financial “shell” holding company, and the group avoids the requirements of section 4 of chapter V altogether. This is the case even if every other enterprise in the group is a financial sector enterprise.

This could lead to a serious gap in the NBS's supervisory capabilities. The risks outlined above are not diminished simply because a group has a non-financial focus. Indeed, they are probably higher in non-financial groups. Industrial and commercial owners and managers are probably less likely than financial owners and managers to be familiar with the concepts of safe and sound banking and the regulatory requirements that pertain to banks. If anything, the NBS needs to be more – not less – concerned about banks' involvement in mixed-activity groups than in purely financial ones.

This problem is not unique to Serbia. The EU banking-related directives, and the banking laws of most EU countries, do not provide comprehensive guidance for the supervision of banks in mixed-activity groups.<sup>194</sup> The following section briefly outlines these issues.

### 3. Mixed Activity Groups and the EU Banking Directive

While the EU Banking Directive undeniably pays more attention to financially-oriented groups than mixed-activity ones, it does contain some provisions concerning the latter groups. It specifically defines a “mixed-activity holding company”<sup>195</sup> and clearly states that the competent authorities of the EU member states must have certain tools with regard to such companies and their groups, not just financially-oriented groups. For example:

---

<sup>193</sup> *Id.* In this sense the Serbian Banking Law is actually even more restrictive than the EU approach. See discussion *infra*.

<sup>194</sup> For a more detailed examination of these issues, See Gary A. Gegenheimer, *Bank Supervisors and Mixed Activity Groups: A Comparison of the European and Australian Approaches and Lessons for Transition Economies*, (forthcoming), 22 BANKING & FIN. L.R. 239 (2007).

<sup>195</sup> EU Banking Directive, *supra* note 55, at art. 4(20) (defining a “mixed activity holding company” as a parent undertaking, other than a financial holding company or a credit institution or a mixed financial holding company within the meaning of the Financial Conglomerates Directive, the subsidiaries of which include at least one credit institution).

- In the case of groups with diversified activities the parent undertakings of which control at least one credit institution subsidiary, the competent authorities must be able to assess the financial situation of a credit institution in such a group....The competent authorities must *at least* have the means of obtaining from *all undertakings* within a group the information necessary for the performance of their function.<sup>196</sup>
- Member States should be able to refuse or withdraw banking licenses in the case of certain group structures considered inappropriate for carrying on banking activities, in particular because such structures cannot be supervised effectively. In this respect, the supervisory authorities should have the necessary powers to ensure the sound and prudent management of banks.<sup>197</sup> The Directive does not specify what an inappropriate group structure might be, or how supervisory authorities should undertake to ensure the sound and prudent management of banks that may be parts of such groups. Clearly, however, this entails, at the very least, reviewing the activities of banks' parent companies and the other group companies in order to assess the safety and soundness of the bank; establishing and enforcing "fit and proper" standards for owners and managers of parent companies; and taking appropriate remedial actions with regard to those parent or other group companies concerning matters that could adversely impact the bank.<sup>198</sup>
- Competent authorities may refuse or withdraw banking licenses if they determine that "close links" between a

---

<sup>196</sup> *Id.* at "whereas" clause 59 (emphasis added).

<sup>197</sup> *Id.* at "whereas" clause 60.

<sup>198</sup> See BASEL COMMITTEE, CORE PRINCIPLES METHODOLOGY, *supra* note 75, at 38 (Principle 23, additional criteria, points 2 and 3); 40 (Principle 24, additional criteria, point 1). See also BASEL COMMITTEE, ENHANCING CORPORATE GOVERNANCE IN BANKING ORGANIZATIONS (updated February 2006) (bank supervisors must be able to obtain information regarding the structure of the group to which a bank belongs, a full list of all group entities affiliated with the bank, the business lines of the group, the adequacy of the oversight process within the group, and all material risks and other issues that may affect the group); MACDONALD *supra* note 163, at 30 (noting that group annual reports and periodic meetings with group management can be very effective tools for assessing the risks to banks in mixed-activity groups).



bank and other natural or legal persons prevent proper supervision of the bank.<sup>199</sup> Such a determination cannot be made without a qualitative assessment of the overall group structure, including an evaluation of the suitability of the group's risk management, internal controls, corporate governance practices and financial situation.

- Competent authorities are obliged to put an end to any situation in which it determines that persons with “qualifying holdings” in a bank (generally the same concept as a “participation” under the Serbian Law on Banks) are acting in a manner that is detrimental to the sound and prudent management of the bank.<sup>200</sup> This determination cannot be made unless the competent authority has the ability to obtain timely and reliable information from and about persons with qualifying holdings. Moreover, the supervisory authority must be able to make a qualitative assessment of the business activities of such persons and their actual or potential impact on the bank, in order to determine whether such remedial action is necessary.
- Competent authorities must have the power to impose sanctions not only against credit institutions (banks), but also against persons who “effectively control the business” of such institutions (which, again, would necessarily include mixed-activity holding companies and their owners and managers), in cases of violations of pertinent laws, regulations or administrative provisions.<sup>201</sup>
- Member States are directed to exercise “general supervision” over transactions between banks and their parent mixed-activity holding companies and subsidiaries of those companies; to require banks to have adequate risk management processes, internal controls and reporting provisions in place with respect to such transactions; and to take “appropriate measures”

---

<sup>199</sup> EU Banking Directive, *supra* note 55, at arts. 12(3), 17(1)(c).

<sup>200</sup> *Id.* at art. 21(2).

<sup>201</sup> *Id.* at art. 54.

where any such transactions would constitute a threat to the bank's financial position.<sup>202</sup>

#### 4. A Suggested Methodology for Dealing with Mixed Activity Groups

Fortunately, the new Banking Law gives the NBS the authority to accomplish, via implementing by-laws, many of the same kinds of things with regard to mixed-activity groups that it can accomplish with regard to banking groups and to achieve compliance with the EU Banking Directive. The NBS should utilize this authority vigorously.

For international guidance in this process, the NBS should consult the analogous provisions adopted by the Australian Prudential Regulatory Authority (APRA). APRA has promulgated supervisory guidelines relating to "conglomerate groups," meaning any group of companies containing one or more "authorized depository institutions" (i.e., banks, or "ADIs").<sup>203</sup> Many of the consolidated supervision provisions of the Serbian Banking Law were patterned largely on the APRA model; the critical distinction is that in the Serbian case, applicability is limited to groups containing exclusively financially-oriented enterprises, whereas in Australia a conglomerate group may include non-financial as well as financial entities, regulated or unregulated.<sup>204</sup> The requirements of group transparency,<sup>205</sup> group-wide risk management policies,<sup>206</sup> and fit and proper management<sup>207</sup> apply to all conglomerate groups, regardless of whether the group is purely financial or a wider mixed activity group. With regard to capital adequacy, APRA recognizes that it is not practical to apply bank capital rules to mixed activity groups. It therefore takes a flexible approach and tailors the capital requirements for each group to its particular characteristics.<sup>208</sup>

---

<sup>202</sup> *Id.* at art. 138.

<sup>203</sup> APRA Conglomerate Policy, *supra* note 178, at 4, ¶ 1. In Australia, a "group" of companies includes a parent company and its subsidiaries, but does not include the EU concept of "participations."

<sup>204</sup> *Id.* at 4, ¶ 2.

<sup>205</sup> *Id.* at 5, ¶ 8.

<sup>206</sup> *Id.* at ¶ 30.

<sup>207</sup> *Id.* at 7, ¶¶ 21-22.

<sup>208</sup> *Id.* at 11, ¶ 44. Most Australian banks do not have significant corporate affiliations with non-financial enterprises, and for those banks, the Level 1 and Level 2 requirements are adequate. See APRA, *Capital Adequacy and Exposure Limits for Conglomerate Groups Including ADIs* (Discussion Paper October 2001) 3 [hereinafter *Conglomerate Capital and Exposure Policy*]. A handful of conglomerate groups, however, have characteristics that make the application of the Basel rules impractical. For these groups, APRA applies a more flexible approach. Only conglomerate groups designated by APRA must meet these requirements. *Id.* Each such "prescribed

Article 94 of the Serbian Banking Law gives the NBS broad authority to require virtually any data that the NBS deems appropriate in making a decision as to whether to approve a request to acquire ownership in a bank at or above certain benchmarks.<sup>209</sup> Pursuant to this authority, the NBS undoubtedly could require any person to submit data about other persons with which the applicant has "close links" as defined in the Banking Directive.<sup>210</sup> If the bank would be part of a group as a result of the acquisition, the NBS could use this authority to inquire about the structure of the group, the quality of its management, its business activities, corporate governance practices, risk management and so forth.

Once approval is given for a banking license under Article 16 or for an acquisition under Article 94, bank participants are obliged to furnish the NBS with updated data periodically, at times determined by the NBS and at least once per year.<sup>211</sup> The message and intent of Article 101 are clear: the NBS must have continuing knowledge of the group's structure, quality of management, risk-management, internal controls and corporate governance practices.

In general, the kind of "core" data that the NBS should require from mixed-activity groups should not differ radically from the information that it requires from pure banking groups. The principal difference is that certain numerically-based prudential requirements, such as capital adequacy requirements and large exposure limitations, would not be applicable to mixed activity holding companies or the non-bank members of such groups. The NBS should, however, be satisfied as to the content of the holding company's

---

conglomerate" has to have an APRA-approved group structure and must adopt an APRA-approved, group-wide capital calculation from a menu of options which takes into account all of the group's members, whether banks, insurers or unregulated entities, and the capacity of any surplus capital to be moved around the group according to need. APRA *Conglomerate Capital and Exposure Policy*, *supra* at 5-6. The menu of options is based on the methodologies put forward by the Joint Forum on Financial Conglomerates, although banks can propose their own internal capital estimation and allocation models. *Id.* The bank must satisfy APRA that the conglomerate group of which it was a part has sufficient capital (defined according to the standard Basel Committee Tier 1 and Tier 2 definitions) for the risk profile of the group as a whole. *Id.* Where APRA is not satisfied with the group-wide assessment, it may impose additional capital requirements upon the bank. *Id.* at 6.

<sup>209</sup> Serbian Banking Law, *supra* note 1, art. 94, ¶ 3.

<sup>210</sup> See EU Banking Directive, *supra* note 55, art. 4, ¶ 46 (defining "close links" as a situation in which two or more natural or legal persons are linked by a "participation" or "control" relationship; a situation in which two or more natural or legal persons are permanently linked to one and the same person by a control relationship is also regarded as constituting a close link between those persons).

<sup>211</sup> Serbian Banking Law, *supra* note 1, art. 101.

and group's risk management policies, so that the bank will not be exposed to undue risk. The NBS should also be satisfied as to the group's transparency. It should be easy for the NBS to determine who the real controlling participants of the bank are, and the mutual relationships between the bank and the other members of the group. Finally, the NBS should be satisfied as to the business reputation and professional qualifications of all members of management bodies of legal entities with participations in banks.<sup>212</sup>

With so many Serbian banks being subsidiaries of foreign entities, the NBS should make it a condition of approval for owning a Serbian bank that the parent company provide the NBS with all of the information that it needs to properly supervise the bank. A foreign parent that does not agree to provide this information should not have its application approved, and a parent that does not provide the information after having agreed to do so should have its approval revoked.<sup>213</sup>

It remains to be seen whether, and how, the NBS will actually utilize this considerable authority.

### ***E. External Audits***

Currently, the auditing and accounting profession in Serbia is considered poor and capacity is limited.<sup>214</sup> The new Banking Law seeks to remedy this situation, to the extent possible, by requiring all banks to undergo an annual external audit and generally adopting a number of EU-friendly provisions.

Under the previous law, the legal requirements relating to external audits of banks were quite sparse. Moreover, the requirements were scattered between the Banking Law and Law on the National Bank.

Articles 36 through 38 of the previous Banking Law required that each bank have its annual statement of accounts audited within six months of the close of the calendar year, that the report had to be presented to the bank's

---

<sup>212</sup> See Gegenheimer, *Bank Supervisors and Mixed Activity Groups*, *supra* note 194 at 284-88.

<sup>213</sup> A comparable provision is found in the APRA Conglomerate Policy, *supra* note 178 at 4, ¶ 4 (stating that a foreign conglomerate group containing an Australian bank must satisfy APRA that it is subject to regulatory oversight broadly consistent with that applied by APRA with regard to Australian conglomerate groups).

<sup>214</sup> International Monetary Fund, *Serbia and Montenegro: Serbia—Financial System Stability Assessment, including Reports on the Observance of Standards and Codes on the following topics: Monetary and Financial Policy Transparency, Banking Supervision, and Payment Systems*, Country Report 06/96, Mar. 2006, at 19.

supervisory board, and that the bank's financial statements had to be published every year.<sup>215</sup> Article 77 of the Law on the National Bank required banks to furnish the NBS and Minister of Finance with their auditors' reports by July 15th of each year.<sup>216</sup> Article 61 of the NBS Law provided that the NBS would prescribe the minimum scope of auditing and audit reports for banks, and could require banks to furnish it with audit reports.<sup>217</sup>

These provisions were desirable, but more were necessary. In particular, the law did not address the relationship between the external auditors and the NBS. This relationship, however, is critical to the supervisory function.<sup>218</sup>

The new Banking Law seeks to remedy this situation by upgrading the external audit requirements considerably. The new requirements are a blend of EU provisions and internal banking legislation of EU and Basel Committee countries.

Each bank, banking group, and bank holding company must annually hire an external auditor and notify the NBS within fifteen days from the day of such appointment.<sup>219</sup> The NBS determines and publishes a list of external auditors that can perform auditing of banks on the basis of criteria it prescribes.<sup>220</sup>

A bank may not appoint an external auditor whose income from auditing that bank in the previous year exceeds one-half of the external auditor's total income.<sup>221</sup> The external auditor may conduct not more than three consecutive annual financial statements audits of the bank.<sup>222</sup> The external auditor may not conduct both an audit of the bank's financial statements and provide consulting services to such bank during the same year, nor may they conduct an audit for the business year in which they provided consulting services to such bank.<sup>223</sup> Should an audit be performed by the external auditor who is not included in the list specified in Article 52, and/or if

---

<sup>215</sup> 1993 Banking Law, *supra* note 4, arts. 36-38.

<sup>216</sup> Law on the National Bank, *supra* note 39, art. 77.

<sup>217</sup> *Id.* at art. 61.

<sup>218</sup> See BASEL COMMITTEE, CORE PRINCIPLES METHODOLOGY, *supra* note 75, at 36-37; Basel Committee, THE RELATIONSHIP BETWEEN BANK SUPERVISORS AND BANKS' EXTERNAL AUDITORS (January 2002).

<sup>219</sup> Serbian Banking Law, *supra* note 1, art. 52.

<sup>220</sup> *Id.*

<sup>221</sup> *Id.* at art. 53.

<sup>222</sup> *Id.*

<sup>223</sup> *Id.*

the audit has been conducted in breach of provisions of this Law and other regulations, the NBS cannot accept the auditor's report.<sup>224</sup>

The audit manager must have the highest professional degree in the field of auditing, in compliance with the law that governs auditing, three years of experience in conducting audits of banks, and must be independent of the bank. Independence means that the person is not, and during the two previous business years, has not been:

- (1) ...a person related to the bank or any member of the banking group;
- (2) ...a business partner of the bank or any member of the banking group;
- (3) ...a person with direct or indirect ownership in the bank or any member of the banking group;
- (4) ...a liquidation administrator or a receiver of a member of the banking group;
- (5) ...a contractual party in a contractual relationship with a person who might have a negative impact on his impartiality and independence.<sup>225</sup>

Annual audits of banking groups' financial reports must be performed on a consolidated basis.<sup>226</sup> Each subordinated company of a bank or a bank holding company must also provide external audits of its individual annual financial statements.<sup>227</sup> Such audits must be performed by the external auditor appointed by the ultimate parent company of a banking group.<sup>228</sup> With the consent of the NBS, a non-banking subordinated company need not be included in the audit specified if:

---

<sup>224</sup> *Id.*

<sup>225</sup> *Id.* at art. 54.

<sup>226</sup> Compare *id.* at art. 55 with Croatian Banking Law, *supra* note 184, art. 112(1) (requiring annual external audit for the entire banking group); Estonian Credit Institutions Act, *supra* note 76, § 93(3) (requiring that companies belonging to the same "consolidation group" as a credit institution must be audited by at least one common auditor); Canadian Bank Act, *supra* note 70, § 860 (a bank holding company must take all necessary steps to ensure that each of its subsidiaries has the same auditor as the bank holding company); and APRA Conglomerate Policy, *supra* note 178, §§ 61-63 (referring to a group external auditor).

<sup>227</sup> Serbian Banking Law, *supra* note 1, art. 55.

<sup>228</sup> *Id.*

- (1) its capital according to the balance sheet is less than 5% of total capital of the bank, according to the balance sheet of the bank, and/or bank holding company;
- (2) the subordinated company has realized less than 5% of the income of the bank, and/or bank holding company during the previous business year.

Additionally, with the consent or upon the request of the NBS, the non-banking subordinated company need not be included in the audit of the banking group if, in the opinion of the NBS, such non-inclusion would contribute to the objective perception of the financial situation of the group.<sup>229</sup>

The external auditor must prepare a report and provide an opinion as to whether the annual financial statement of the bank has been composed in compliance with International Financial Reporting Standards or International Accounting Standards, law which governs accounting and audit and regulations of the NBS, and whether it provides true and objective overview of the bank's financial position, business results and cash flows for the business year regarding all issues of material importance.<sup>230</sup> The external auditor must also provide his opinion regarding the efficiency of the functioning of the internal audit, systems of risk management and internal control to the bank's board of directors and executive board, as well as to the NBS.<sup>231</sup>

Serbia has joined a growing number of countries that require external auditors to report irregularities that they uncover in the course of their audits. The external auditor must notify the board of directors and executive board of a bank, and/or a member of the banking group, as well as the NBS promptly after becoming aware of any fact that represents:

- (1) Violation of the law or by-laws of the National Bank of Serbia;
- (2) Materially important change in the financial result carried in annual financial statements which have not been audited;
- (3) Violation of internal procedures or enactments of the bank or the group to which the bank belongs;

---

<sup>229</sup> Compare *id.* with EU Banking Directive, *supra* note 55, art. 73.

<sup>230</sup> Serbian Banking Law, *supra* note 1, art. 56.

<sup>231</sup> *Id.*

- (4) Any circumstances that could result in a material loss for the bank or a member of the banking group or that could jeopardize their continuous business operations.<sup>232</sup>

Such notification is not considered a violation of secrecy of the bank's data or confidential information, and the external auditor shall not bear responsibility because of it.<sup>233</sup>

When the irregularities in the activities of the bank are established in the external auditor's report, the bank must eliminate those irregularities and inform the NBS of its progress, and failure to do so may lead to stronger enforcement measures.<sup>234</sup>

A bank and bank holding company must notify the NBS in writing regarding resignation or removal of the external auditor of a bank, bank holding company or banking group, including a statement of the reasons for the resignation and/or removal fifteen days following the day of the resignation and/or removal.<sup>235</sup> When this occurs, no other external auditor may accept an appointment as auditor of the bank, bank holding company or banking group, unless they obtain the written statement of the previous auditor.<sup>236</sup> An exception is allowed if the new auditor has not received such a statement within fifteen days following its request, provided the new auditor notifies the NBS of this fact.<sup>237</sup> The NBS is not permitted to accept the report of an auditor who was appointed for the function unless they have requested the statement, or if they have accepted the appointment before the specified deadline has expired.<sup>238</sup>

<sup>232</sup> Compare *id.* at art. 58 with EU Banking Directive, *supra* note 55, art. 53(1); Croatian Banking Law, *supra* note 184, art. 113(2), (3); German Banking Act, *supra* note 67, § 29(3); Swiss Banking Act, *supra* note 67, art. 21(3), (4); Estonian Credit Institutions Act, *supra* note 76, §95(1); Latvian Credit Institution Law, art. 88(2), available at <http://unpan1.un.org/intradoc/groups/public/documents/UNTC/UNPAN018386.pdf>, (last visited Dec. 12, 2007); Canadian Bank Act, *supra* note 70, § 328(2)(d).

<sup>233</sup> Serbian Banking Law, *supra* note 1, art. 56.

<sup>234</sup> *Id.* at art. 59

<sup>235</sup> *Id.* at art. 60. This provision and the immediately following ones are modeled on the Canadian Bank Act, *supra* note 70, art. 321, 322 (banks) and arts. 853, 854 (bank holding companies). See also U.S. Federal Deposit Insurance Act, section 36(g)(5), 12 U.S.C. § 1831m(g)(5).

<sup>236</sup> *Id.* This appears to be a drafting error: paragraph 1 refers to a written statement that must be furnished by the bank or bank holding company to the NBS; paragraph 2, by contrast, is about a statement that must be composed by the auditor.

<sup>237</sup> *Id.*

<sup>238</sup> Serbian Banking Law, *supra* note 1, art. 56.



A bank must submit to the NBS individual financial statements of the bank and its bank holding company together with the external auditor's report for the preceding business year -within 120 days after the end of such year.<sup>239</sup> The NBS may also require any member of the banking group to submit individual financial statements together with the external auditor's report.<sup>240</sup> A bank must submit consolidated financial statements of the banking group together with the auditor's report for the previous business year within 150 days after the end of such year.<sup>241</sup>

Banks and bank holding companies must publish their external audit reports in an abbreviated form in at least one of the daily newspapers distributed in the whole territory of the Republic of Serbia within fifteen days after receiving such report.<sup>242</sup> Each bank must also publish on its website a complete report of the external auditor on annual financial statements regarding the bank, bank holding company and banking group, including notes to the financial statements.<sup>243</sup> In addition to publishing the audited annual financial statement, a bank must publish quarterly unaudited financial statements within thirty days following expiration of the appropriate accounting period.<sup>244</sup> If an error has been noticed in the published reports and data, the bank or the external auditor must promptly inform the NBS of the error, and the bank must publish a corrected report.<sup>245</sup>

Should the NBS determine the audit of the bank, bank holding company or banking group has not been performed in compliance with provisions of the Law, the NBS must not accept such audit report and must require that another external auditor perform the audit again at the bank's expense.<sup>246</sup>

The NBS may require a special audit of a bank or a banking group member, by a special auditor appointed by the NBS, if the reports of the bank or members of the banking group are inaccurate, or the concluded transactions

---

<sup>239</sup> *Id.* at art. 61.

<sup>240</sup> *Id.*

<sup>241</sup> *Id.*

<sup>242</sup> *Id.*

<sup>243</sup> Serbian Banking Law, *supra* note 1, art. 61.

<sup>244</sup> *Id.*

<sup>245</sup> *Id.* Cf. Estonian Credit Institutions Act, *supra* note 76 § 92(3).

<sup>246</sup> Compare Serbian Banking Law, *supra* note 1, art. 62 with Croatian Banking Act, *supra* note 184, art. 114(4), (5).

may have or have resulted in significant damage to the bank.<sup>247</sup> The bank bears the costs of such special audits.<sup>248</sup>

#### ***F. Prompt Corrective Action and Enforcement Measures***

The new Serbian law adopts a problem bank regime based largely on the American “prompt corrective action” concept.

A bank is considered “undercapitalized” if its “capital adequacy ratio is below the one prescribed by the NBS, and/or if its capital is lower than the prescribed amount, but which is not a significantly undercapitalized bank.”<sup>249</sup> The term “significantly undercapitalized” applies to a bank “whose capital adequacy ratio is, by one-third or more, lower than the prescribed one, and/or whose capital is, by one-third or more, lower than the prescribed amount, but which is not a critically undercapitalized bank.”<sup>250</sup>

If a bank becomes undercapitalized, it must promptly inform the NBS, and must submit information containing the reasons why the bank is undercapitalized.<sup>251</sup> An undercapitalized bank may not:

- (1) Engage in any new lines of business without the consent of the National Bank of Serbia;
- (2) Increase its risk-weighted assets without the consent of the National Bank of Serbia;
- (3) Pay dividends or perform distributions of capital in any form;
- (4) Pay higher than defined fees to members of the bank’s board of directors and executive board.<sup>252</sup>

A significantly undercapitalized bank is bound by the aforementioned restrictions, and in addition, may not:

- (1) Accept new deposits;

<sup>247</sup> Compare Serbian Banking Law, *supra* note 1, art. 63 with Canadian Bank Act, *supra* note 70, § 325(2)-(4); and Estonian Credit Institutions Act, *supra* note 76, § 102.

<sup>248</sup> Serbian Banking Law, *supra* note 1, art. 63.

<sup>249</sup> Compare *id.* at art. 2 with 12 U.S.C. § 1831o(b)(1)(C).

<sup>250</sup> Compare Serbian Banking Law, *supra* note 2, art. 2 with 12 U.S.C. § 1831o(b)(1)(D).

<sup>251</sup> Serbian Banking Law, *supra* note 1, art. 110, ¶1.

<sup>252</sup> *Id.* at ¶ 2.

- (2) Pay interest rates on deposits in excess of average market ones;
- (3) Increase salaries or other form of compensation for work, or pay any bonuses to members of the bank's board of directors and executive board;
- (4) Conclude legal transactions with related persons without the consent of the National Bank of Serbia, and/or undertake transactions on behalf of related persons or persons related to related persons.<sup>253</sup>

If a bank becomes "critically undercapitalized" – meaning that its capital adequacy ratio is, by one-half or more, lower than the prescribed one, and/or whose capital is, by one-half or more, lower than the prescribed amount<sup>254</sup> – the law requires that the NBS revoke its license.<sup>255</sup> There are also provisions for corrective orders and management removals for more routine violations and circumstances that may endanger the bank.<sup>256</sup>

### ***G. Problem Bank Resolution***

Serbia has generally received high marks from the international development community for its efforts in dealing with defunct banks.<sup>257</sup> The legal mechanisms that have helped to accomplish this were largely put in place during the 2001-05 period. The 2005 Law on Bankruptcy and Liquidation of Banks and Insurance Companies<sup>258</sup> replaced the former Law on Rehabilitation, Bankruptcy and Liquidation of Banks and related provisions of the Law on Insurance.<sup>259</sup> The new law provides a skeletal framework for resolving the affairs of failed banks, though many, if not most, of the substantive provisions are located in the general Bankruptcy Law.

---

<sup>253</sup> *Id.* at art. 111, ¶ 2.

<sup>254</sup> Compare Serbian Banking Law, *supra* note 1, art. 2, with 12 U.S.C. § 1831o(b)(1)(E).

<sup>255</sup> Compare Serbian Banking Law, *supra* note 1, art. 130, ¶ 1(1), with 12 U.S.C. § 1831o(h)(3).

<sup>256</sup> Serbian Banking Law, *supra* note 1, arts. 112, 114-116.

<sup>257</sup> See World Bank Report No. 29258-YU: *Serbia and Montenegro – Republic of Serbia, An Agenda for Economic Growth and Employment* (2004), at 80, n. 105; International Monetary Fund, *Joint Staff Assessment of the Poverty Reduction Strategy Paper* Country Report No. 04/117 (2004), at 1.

<sup>258</sup> Bank Bankruptcy Law, *supra* note 2.

<sup>259</sup> See *id.* at art. 31.

In overhauling its bank resolution procedures, Serbia has joined a number of European countries that are moving away from a strictly court-centered regime of bank resolution and toward an administrative process, under which most of the work is done by a specialized body, such as the bank supervisor or deposit insurer, that is intimately familiar with the special problems involved in resolving the affairs of failed banks.<sup>260</sup> In Serbia, the Deposit Insurance Agency has been given this task.<sup>261</sup> There are three possible ways of winding up the affairs of a bank that has become insolvent or that the NBS determines should exit the system: bankruptcy, liquidation, or merger with a healthy bank. Conceptually, this is a generally acceptable structure and framework, but “the devil is in the details.” Serbia has not completely abandoned the court-centered approach. Moreover, there is a definite lack of clarity on some critical issues, and some additional options would be desirable.

As an initial matter, the use of the words “bankruptcy” or “insolvency” to refer to the process of winding up the affairs of a defunct bank can be a source of confusion. While many banking laws (especially in transition economies) and much bank supervisory literature do use these words to describe the bank resolution process,<sup>262</sup> this author has always been

---

<sup>260</sup> In Europe, problem bank resolution traditionally has been a judicial function, conducted under the general insolvency law and administered by the ordinary courts that conduct bankruptcy matters. The rationale for this approach is that bank supervisors should deal only with “living” banks, while “fatally ill” or “dead” banks should be turned over to the “mortician,” the bankruptcy court. The theory is that since such an entity can no longer conduct the business of banking, it is “no longer a bank” and thus should be treated just like any other bankrupt enterprise. This is gradually changing as more countries recognize that ordinary courts do not have the specialized expertise that bank supervisors and deposit insurers have in dealing with these issues. A good example can be seen in Switzerland, which adopted extensive amendments to its Banking Act in 2003 to give the Federal Banking Commission broad powers to reorganize or liquidate banks whose licenses it has revoked, or which encounter serious financial problems. Swiss Banking Act, *supra* note 67, Sections XI (Measures in Case of the Risk of Insolvency), XII (Liquidation of Insolvent Banks (Bank Bankruptcy)). For a more complete discussion of this topic, see Eva H.G. Hüpkes, *Learning Lessons and Implementing a New Approach: Bank Insolvency Resolution in Switzerland*, in WHO PAYS FOR BANK INSOLVENCY? (David G. Mayes & Aarno Liuksila eds., 2004) [hereinafter *Bank Insolvency Resolution in Switzerland*]; Eva H.G. Hüpkes, *Insolvency: Why a Special Regime for Banks?* in CURRENT DEVELOPMENTS IN MONETARY AND FINANCIAL LAW Vol. 3 (IMF, 2003) [hereinafter *Why a Special Regime*].

<sup>261</sup> Bank Bankruptcy Law, *supra* note 2, art. 7, ¶ 2; art. 22 (assigning to the Agency the task of the bankruptcy administrator and liquidation administrator, respectively, for failed banks and insurance companies).

<sup>262</sup> See, e.g., Hüpkes, *Why a Special Regime?*, *supra* note 260; Robert R. Bliss and George G. Kaufman, *U.S. Corporate and Bank Insolvency Regimes: An Economic Comparison and Evaluation*, Federal Reserve Bank of Chicago Working Paper 2006-

uncomfortable with this terminology. Ultimately, the real issue is not “bankruptcy” or “insolvency;” rather, it is about how to deal with the situation of a bank that, in the judgment of the bank supervisory authority, should no longer be allowed to continue to operate in its current form. While most banks in this category may in fact turn out to be insolvent, this is not invariably the case. The reasons for the supervisor’s determination can be considerably broader than insolvency or bankruptcy, and can include gross violations of legal requirements, untrustworthy management, lack of transparency of ownership, and others.<sup>263</sup> Provisions must be made for resolving the affairs of these banks, as well as those banks that can be considered insolvent or bankrupt under traditional bankruptcy or company law concepts. Otherwise, the bank supervisor will be saddled with a non-operating “former” bank that cannot be liquidated or wound up, obviously not a good scenario.

The following sections explore these issues further.

---

01                    1                    n.1                    (2006),                    available                    at  
http://papers.ssrn.com/sol3/papers.cfm?abstract\_id=878355; Federal Law No. 40-Fz of February 25, 1999 On Insolvency (Bankruptcy) of Credit Institutions (as amended Aug. 20, 2004) (Rus.); Law No. 14 of February 15, 2004 of the Kyrgyz Republic on Conservation, Liquidation and Bankruptcy of Banks (as amended by Law No. 47, Mar. 10, 2005) (Kg); Swiss Banking Act, *supra* note 67.

<sup>263</sup> See, e.g., Swiss Banking Act, *supra* note 67, art. 23(5) (authorizing license revocation and forcible liquidation for “gross violations of legal requirements”); U.S. Federal Deposit Insurance Act, section 11, 12 U.S.C § 1821 (authorizing appointment of a conservator or receiver for a bank on the basis of, among other things, an “unsafe or unsound condition to transact business,” “violations of law, regulation, or an unsafe or unsound practice that is likely to seriously prejudice the interests of the depositors or the deposit insurance fund”); German Banking Act, *supra* note 67, §§ 35 and 38 (authorizing license revocation and resultant liquidation if grounds exist that would warrant refusal of the license, or if the safety of assets entrusted to a bank is “endangered”); Canadian Bank Act, *supra* note 70, §§ 648 – 651 (authorizing the Superintendent of Financial Institutions to take control of a bank if, among other grounds, he determines that “a practice or state of affairs that may be materially prejudicial to the interests of the bank’s depositors or creditors or the owners of any assets under the bank’s administration.” The Superintendent may petition the court for a winding-up order with respect to any bank that is under his control); Estonian Credit Institutions Act, *supra* note 76, § 17(11)(authorizing license revocation if a bank’s “activities cause significant damage” to the interests of depositors.); French Monetary and Financial Code, art. L613-21, L613-22 (a bank may be deleted from the list of authorized institutions as a disciplinary sanction; such striking off entails liquidation of the bank. Such sanctions may be imposed if the bank has contravened a law or regulation relating to its business, has not responded to a recommendation, has not heeded a cautionary notice, or has not complied with an injunction issued by the Banking Commission). See generally TOBIAS M.C. ASSER, LEGAL ASPECTS OF REGULATORY TREATMENT OF BANKS IN DISTRESS 124-26, 149-51 (International Monetary Fund, 2001); Bliss and Kaufman, *supra* note 262.

## 1. What Law Applies?

The question of exactly what law applies to the case of winding up the affairs of a defunct bank is not entirely clear. The Bankruptcy Law clearly states that it does not apply to bankruptcy proceedings involving banks or insurance companies, except for areas that are not covered by special legislation involving those entities.<sup>264</sup> On the other hand, the Bank Bankruptcy Law provides that with a few specified exceptions, bankruptcy and liquidation matters involving banks and insurance companies are governed by the general bankruptcy law, unless the Bank Bankruptcy Law provides otherwise.<sup>265</sup> Because the content of the Bank Bankruptcy Law is so sparse, as a practical matter it is inevitable that the Bankruptcy Law will need to be consulted in a number of situations involving banks.

### 2. “Bankruptcy” or “Liquidation:” A Distinction Without a Difference?

According to the Serbian Banking Law, the NBS is required to revoke a bank’s license if the bank:

- (1) is critically undercapitalized;
- (2) fail[s] to enable the National Bank of Serbia to perform supervision of safety and soundness and legal compliance of its activities;
- (3) continuously ceased to engage in activities of receiving deposits or granting credits during six months, except if it has been ordered to do so by the corrective measure declared by the National Bank of Serbia.<sup>266</sup>

The National Bank of Serbia may [also] revoke [a] bank’s license if:

- (1) the bank has critically strained liquidity;
- (2) [the NBS] determines that the bank’s operating license was issued on the basis of false data;
- (3) the bank’s founder withdraws the funds invested in the initial capital of the bank;

---

<sup>264</sup> Bankruptcy Law, RS Official Gazette No.84/04 (2005), art. 6, ¶ 2.

<sup>265</sup> Bank Bankruptcy Law, *supra* note 2, arts. 19, 21.

<sup>266</sup> Serbian Banking Law, *supra* note 1, art. 130, ¶1.

- (4) the bank fails to commence its operations within 60 days following entry into the register of economic entities;
- (5) [the NBS] determines that conditions specified in Article 16, paragraph 1, items 5 and 6 and Article 19, paragraph 1 of [the Banking] Law are no longer met;
- (6) the bank is significantly undercapitalized;
- (7) the undercapitalized bank fails to meet any of the business indicators prescribed by [the Banking] Law or bylaws of the National Bank of Serbia;
- (8) [the NBS] establishes that the bank has committed gross or persistent violations of the law or other regulation;
- (9) within the prescribed time period, the bank fails to act in compliance with the orders specified in Article 116 of [the Banking] Law;
- (10) the bank fails to pay [the] deposit insurance premium in compliance with the law which governs deposit insurance; [or]
- (11) the activities of the bank are related to money laundering, financing of terrorism, or performing other punishable acts.<sup>267</sup>

Revocation of a bank's license, however, is only the first step in the resolution process. Once the NBS revokes a bank's license, it must make a determination: whether to proceed under a "bankruptcy" scenario or under a "liquidation" scenario.<sup>268</sup> It is also possible for a bank that has been placed in bankruptcy or liquidation to be taken over by a healthy bank.<sup>269</sup>

The grounds for initiating bankruptcy proceedings with respect to a bank are set forth in Article 2 of the Bank Bankruptcy Law, which provides that bankruptcy proceedings may be initiated with respect to a bank whose operating license has been revoked *and* which has been illiquid for fifteen days continually, or whose liabilities exceed its assets.<sup>270</sup> Bankruptcy proceedings

---

<sup>267</sup> *Id.* at art. 130, ¶ 2.

<sup>268</sup> *Id.* at art. 130, ¶ 3.

<sup>269</sup> *See id.* at art. 134.

<sup>270</sup> Bank Bankruptcy Law, *supra* note 2, art. 2 (emphasis added).

may also be undertaken upon the request of a liquidation administrator, determining that the debtor entity's assets are not sufficient to settle all creditors' claims.<sup>271</sup>

This material is inconsistent with Article 130 of the Banking Law, which provides that bankruptcy proceedings with regard to a bank are undertaken only when the bank's obligations exceed its property,<sup>272</sup> rendering the "illiquid for fifteen days" test of the Bank Bankruptcy Law rather pointless. So, if a bank's license has been revoked, and it has been illiquid for fifteen days, but it still has a minimally positive net worth, it would be possible to initiate bankruptcy proceeding under the Bank Bankruptcy Law but not under the Banking Law.

If a bank does not meet the criteria for "bankruptcy," the alternative course for winding up its affairs is liquidation (assuming a voluntary acquirer or merger partner does not materialize).<sup>273</sup> In either case, the winding up process is governed by the Bankruptcy Law, subject to any specific provisions regarding banks that may be found in the Bank Bankruptcy Law.<sup>274</sup> The Bankruptcy Law, however, does not clearly distinguish between "bankruptcy" on the one hand, and "forced liquidation" on the other, as the Bank Bankruptcy and Banking Laws would suggest.

According to the Bankruptcy Law, there are two types of bankruptcy proceedings: liquidation and reorganization,<sup>275</sup> and the latter scenario does not apply to banks.<sup>276</sup> Thus, liquidation is merely one type of bankruptcy proceeding.<sup>277</sup> Viewed another way, once a bank's license is revoked, the only way to wind up its affairs are through liquidation or merger with a healthy bank. If the criteria for bankruptcy are met, then the proper course of action is

---

<sup>271</sup> *Id.* In the case of a bank, the "liquidation administrator" is the Deposit Insurance Agency.

<sup>272</sup> Serbian Banking Law, *supra* note 1, art. 130, ¶ 4.

<sup>273</sup> See Bank Bankruptcy Law, *supra* note 2, art. 3, ¶ 2.

<sup>274</sup> *Id.* at art. 19 (providing that except as otherwise prescribed by the Bank Bankruptcy Law, provisions of the law governing the bankruptcy of economic entities, except for provisions on previous bankruptcy proceedings, bankruptcy judge, the board of creditors and re-organization, apply to bankruptcy proceedings of banks and insurance companies); *id.* at art. 21 (providing that the provisions of the general bankruptcy law apply to liquidation of banks and insurance companies, except for the provisions relating to the board of creditors, individual creditors, refutation of legal actions, deposit insurance and pay-out lines).

<sup>275</sup> Bankruptcy Law, *supra* note 264, art. 1.

<sup>276</sup> Bank Bankruptcy Law, *supra* note 2, art. 19.

<sup>277</sup> See Bankruptcy Law, *supra* note 264, Ch. IX ("Conversion into Cash and Distribution of the Bankruptcy Estate, Settlement and Conclusion of Bankruptcy Proceedings").



“bankruptcy;” there are two methods of proceeding in bankruptcy – reorganization and liquidation – and since reorganization does not apply to the case of a defunct bank, liquidation is the “default” position. If, on the other hand, the bankruptcy criteria are not met, then the proper course of action is liquidation. Thus, where there is no voluntary acquirer or merger partner, liquidation is undertaken in any event.

### 3. Who Can Initiate Proceedings?

Another question is whether the NBS is exclusively authorized to initiate bankruptcy proceedings with regard to a bank. Neither the Banking Law, nor the Bank Bankruptcy Law affirmatively addresses this issue. While the Bank Bankruptcy Law refers to the NBS’s decision on bankruptcy being forwarded to the competent court,<sup>278</sup> it is an open question as to whether other parties could also initiate the process under the Bankruptcy Law, given the uncertainty as to that law’s applicability to situations involving banks.<sup>279</sup> Under the Bankruptcy Law, a number of parties can submit a petition to initiate bankruptcy proceedings:

- a creditor;
- the bankruptcy debtor;
- the Public Attorney’s office in charge, in the name of legal entities it represents according to law, and which are creditors;
- the Public Prosecutor in charge, if the bankruptcy debtor is insolvent and there is probable cause that the insolvency is linked to committing a crime that has to be prosecuted *ex officio*; or
- the Tax Administration.<sup>280</sup>

Assuming that any of these parties could submit a petition with regard to a bank, the question then becomes, what must that party show in order to initiate the proceeding?

Under the Bankruptcy Law, a creditor may initiate a bankruptcy proceeding if he can prove that the existence of his claim is probable and that

---

<sup>278</sup> Bank Bankruptcy Law, *supra* note 2, art. 6.

<sup>279</sup> See discussion *supra* at Part G 1.

<sup>280</sup> Bankruptcy Law, *supra* note 264, art. 40.

the debtor's insolvency is likely to exist.<sup>281</sup> The Bankruptcy Law defines "insolvency" in terms of ability to pay debts. A debtor is considered to be unable to pay its debts when:

- (1) it cannot respond to its obligations within 45 days from the time they became due;
- (2) it has stopped all payments during a continuous 30 day period; or
- (3) the debtor shows that it is probable that it will not be able to pay existing obligations when they become due.<sup>282</sup>

Quite apart from the fact that these tests are inconsistent with the threshold tests for bankruptcy under the Bank Bankruptcy Law, there is a fundamental question as to whether anyone other than the NBS should be allowed to petition the court to commence insolvency proceedings with respect to a bank. The NBS, through its oversight role, is in a better position than the bank's creditors or other public authority to know whether a banking institution is viable.<sup>283</sup> Putting this decision in the hands of any body other than the bank supervisor is undesirable, because it removes the bank supervisor from the decision as to which banks must exit the system.

The bank supervisory authority typically has better expertise than creditors, judges, and other state bodies to evaluate the situation surrounding a troubled bank and determine the best course of action. Due to its continual supervisory function, the bank supervisor, as opposed to the courts, is already in the possession of the necessary information about the bank, its business structure and its operations. It also has the necessary technical expertise that enables it to act more expeditiously. Given its expertise and proximity to the financial sector, the bank supervisor is better placed to assess whether or not specific measures are appropriate under the circumstances.<sup>284</sup>

For all of these reasons, it is therefore essential that the bank supervisor have the exclusive authority to determine the conditions under which banks will be forcibly liquidated or otherwise resolved. It seems likely

---

<sup>281</sup> *Id.* at ¶ 2.

<sup>282</sup> *Id.* at art. 2

<sup>283</sup> See Hüpkes, *Why a Special Regime*, *supra* note 260, at 8.

<sup>284</sup> *Id.*

that this was the intent of the Serbian drafters, but it would be preferable if this principle were expressly stated.<sup>285</sup>

#### 4. Who Oversees the Proceeding?

Unlike in an ordinary bankruptcy proceeding, a bankruptcy judge is not used in bankruptcy proceedings involving banks.<sup>286</sup> This suggests that the Deposit Insurance Agency, as bankruptcy or liquidation administrator, carries out the resolution process with relative autonomy, with the bankruptcy panel serving as a referee in the event of dispute.<sup>287</sup> However, the law never actually states this.

The Bankruptcy Law calls for a "bankruptcy panel" consisting of three judges.<sup>288</sup> This is an integral part of an ordinary bankruptcy proceeding.<sup>289</sup> The Bank Bankruptcy Law does not mention this body, but requires that there be a "bankruptcy council," without specifying this body's composition, its duties or authorities.<sup>290</sup> Assuming that the bankruptcy council under the Bank Bankruptcy Law is the same thing as the bankruptcy panel under the Bankruptcy Law, a number of issues are present.

Ordinarily, one of the first steps in a bankruptcy case is a decision on "preliminary proceedings," which is issued by the bankruptcy panel. This entails submission by the debtor of relevant financial data<sup>291</sup> and the institution of security measures to prevent the destruction of records or the disappearance of property.<sup>292</sup> Preliminary proceedings can last a maximum of thirty days.<sup>293</sup> Presumably these items do not apply in a case involving a bank since the court is obliged to render a decision on instituting bankruptcy proceedings (not just preliminary proceedings, but the full-blown bankruptcy proceeding) the next

---

<sup>285</sup> Cf. German Banking Act, *supra* note 67, §46b(1) (insolvency petition may only be filed by the BAFin); Austrian Banking Act, *supra* note 124, § 82(1) (normally only the FMA may apply for bankruptcy of a credit institution). The same logic, of course, applies to other parties, such as the public prosecutor, public attorney, and tax authority. The sole authority for determining when a bank should exit the system should be the NBS.

<sup>286</sup> Bank Bankruptcy Law, *supra* note 2, art. 19.

<sup>287</sup> See *id.* at art. 11, point 7.

<sup>288</sup> Bankruptcy Law, *supra* note 264, art. 10.

<sup>289</sup> *Id.* at arts. 10, 11.

<sup>290</sup> Bank Bankruptcy Law, *supra* note 2, art. 7, ¶ 1.

<sup>291</sup> Bankruptcy Law, *supra* note 264, art. 46.

<sup>292</sup> *Id.* at arts. 47, 48.

<sup>293</sup> *Id.* at art. 53, ¶ 1.

business day after receiving the NBS's decision.<sup>294</sup> This is nowhere expressly stated, however.

Next, in an ordinary case, the bankruptcy panel appoints the bankruptcy judge, but since there is no bankruptcy judge in a case involving a bank, this would not be applicable. The panel also appoints and removes the bankruptcy administrator,<sup>295</sup> but since the Deposit Insurance Agency functions as the bankruptcy administrator in the case of a bank,<sup>296</sup> this point is also not applicable in a such cases. The panel also rules on objections against actions of the bankruptcy administrator (again, the Agency in the case of a bank).<sup>297</sup> Another function of the panel, issuing authorization in "singular management," applies only to entrepreneur debtors, so this function would not apply in the case of a bank.<sup>298</sup> The only other function of the panel is a catch-all provision that it "performs other activities stipulated by [the Bankruptcy] law."<sup>299</sup> Thus, out of a list of nine items, only three are really applicable in a case involving a bank: determining whether there is sufficient reason for opening the bankruptcy case, actually issuing the decision to open the case, and ruling on objections to decisions taken by the Agency in its capacity as bankruptcy administrator for the bank.<sup>300</sup>

In addition, the Bankruptcy Law subjects a number of the bankruptcy administrator's functions to the approval or oversight of the bankruptcy judge. For example, the consent of the bankruptcy judge must be obtained before the bankruptcy administrator can act in the following circumstances: creating a plan of the bankruptcy proceedings, including the estimated expenses and timetable; insuring the property of the debtor entity; employing staff members and supervising their work; ascertaining the validity, extent and priority of claims presented by creditors; and preparing a draft main distribution of the bankruptcy estate and the draft of the final bankruptcy balance.<sup>301</sup> In addition, the bankruptcy administrator may obtain unsecured credit or incur secured debt on otherwise unencumbered assets or rights only after notifying the bankruptcy judge and after obtaining the approval of the creditors committee.<sup>302</sup> The bankruptcy administrator must submit monthly reports to

---

<sup>294</sup> Bank Bankruptcy Law, *supra* note 2, art. 6.

<sup>295</sup> Bankruptcy Law, *supra* note 264, art. 11(5).

<sup>296</sup> Bank Bankruptcy Law, *supra* note 2, art. 7, ¶ 2.

<sup>297</sup> Bankruptcy Law, *supra* note 264, art. 11(7).

<sup>298</sup> *Id.* at art. 11(8).

<sup>299</sup> *Id.* at art. 11(9).

<sup>300</sup> *Id.* at art. 11(2), (3) and (7).

<sup>301</sup> Bankruptcy Law, *supra* note 264, art. 17, ¶ 1, points 2, 6, 9, 10, and 12.

<sup>302</sup> *Id.* at ¶ 2.

the bankruptcy judge.<sup>303</sup> Since there is no bankruptcy judge in a proceeding involving a bank, the question becomes, who performs these functions? Logically, the answer should be the NBS, but an argument could be made that it is the bankruptcy panel. Unfortunately, the law does not provide a clear answer.

### 5. The Role of Creditors

The Bank Bankruptcy Law contains two contradictory provisions as to whether a board of creditors is used in bankruptcy proceedings involving banks. Article 7 states that it is, while Article 19 states that it is not.<sup>304</sup> Query, then, how to reconcile these provisions.

A plausible explanation is that the provisions of the Bankruptcy Law regarding the creditors' committee do not apply to banks because there are special provisions in the Bank Bankruptcy Law that govern creditors' committees of banks and insurance companies. Yet the Bank Bankruptcy Law includes only four references to a board of creditors, two of which entail cross-references to the general Bankruptcy Law,<sup>305</sup> and the other two of which merely acknowledge the existence of the board of creditors.<sup>306</sup> There is no indication in the Bank Bankruptcy Law as to what the board of creditors actually does. Presumably, then, the general Bankruptcy Law would apply, and this is problematic. The Bankruptcy Law gives the creditors' committee a huge amount of authority. For example:

---

<sup>303</sup> *Id.* at art. 18, ¶ 8. *See also id.* at art. 12 (listing the functions of the bankruptcy judge).

<sup>304</sup> *Compare id.* at art. 7 (stating that bank bankruptcy proceedings must have a bankruptcy council, a bankruptcy administrator, and a board of creditors) *with id.* at art. 19 (stating that unless otherwise prescribed by this Law, provisions of the Law governing the bankruptcy of economic entities, *except for* provisions on previous bankruptcy proceedings, bankruptcy judge, board of creditors and re-organization, shall apply to bankruptcy proceedings of banks and insurance companies). *See also id.* at art. 21. The Bankruptcy Law actually refers to a "creditors' assembly" and a "creditors' committee," but does not mention a "board of creditors." This appears to be a translation issue. It seems quite clear that the "board of creditors" referred to in the Bank Bankruptcy Law is actually the "creditors' committee" under the general bankruptcy law. This is so because the "creditors' assembly" in the general bankruptcy law consists of all of the creditors, and thus its existence is not in doubt. *See* Bankruptcy Law, *supra* note 264, art. 22, ¶ 2. The creditors' committee, by contrast, is selected from among the creditors – in the case of ordinary enterprises, by the creditors' assembly (*See id.* at art. 24), and in the case of a bank or insurance company, by the bankruptcy council at the request of the Agency (*see* Bank Bankruptcy Law, *supra* note 2, art. 7, ¶ 3).

<sup>305</sup> Bank Bankruptcy Law, *supra* note 2, arts. 19, 21.

<sup>306</sup> *Id.* at art. 7, ¶¶ 1, 3

- Approval of the creditors' committee is necessary for the bankruptcy administrator (in the case of a bank, the Agency) to obtain unsecured credit or incur secured debt on otherwise unencumbered assets or rights.<sup>307</sup>
- Consent of the creditors committee is necessary for actions undertaken by the bankruptcy administrator/Agency that have an impact on the bankruptcy estate, such as obtaining credit or the selling and purchase of the major part of the property ("actions of crucial importance").<sup>308</sup>
- The creditors committee may submit an objection against the final balance to the bankruptcy panel.<sup>309</sup>
- The creditors committee:
  - (1) gives its opinion to the bankruptcy administrator[/Agency] on the manner of selling the [debtor's property], if the property will not be sold through a public auction, and gives its consent on all important issues related to the status of property, [such as] obtaining a credit, [conducting] litigation of higher value, giving a loan etc. in accordance with the procedure set forth in [the Bankruptcy Law];
  - (2) gives its opinion on continuation of the bankruptcy debtor's business operations;
  - (3) reviews the reports of the bankruptcy administrator[/Agency regarding] the course of the bankruptcy proceedings and the status of the bankruptcy estate;
  - (4) reviews and requires, at its own cost, the delivery of copies of complete documentation;
  - (5) informs the Assembly on its work, if requested; [and]

---

<sup>307</sup> Bankruptcy Law, *supra* note 264, art. 17(2).

<sup>308</sup> *Id.* at art. 18(3).

<sup>309</sup> *Id.* at art. 18(8).

- (6) [p]erforms other activities stipulated in the law.<sup>310</sup>
- The creditors committee has the right to:
    - (1) submit a[n] [objection against] the work of the bankruptcy administrator [/Agency] to the bankruptcy judge and to the bankruptcy panel; . . . [and] to submit a[n] [objection against] the conclusions of the bankruptcy judge;
    - (2) appeal against the decision of the bankruptcy judge and the bankruptcy panel, if the possibility to appeal is allowed;
    - (3) review the court records, expert findings and all other documentation of the bankruptcy proceedings;
    - (4) provide its opinion on approving justifiable losses that were encountered during the process of [preparing] the inventory;
    - (5) propose the replacement of the bankruptcy administrator and appointment of a new one [presumably this would not apply in the case of a bank, where the Agency must serve as the bankruptcy administrator]; [and]
    - (6) give an opinion about the amount of the compensation and expense reimbursement to the bankruptcy administrator.<sup>311</sup>
  - If the assets of the debtor include cash, securities or valuables, consent of creditors' committee is necessary for the bankruptcy administrator/Agency to decide on the manner of preserving or investing them.<sup>312</sup>

---

<sup>310</sup> *Id.* at art. 27.

<sup>311</sup> *Id.*

<sup>312</sup> *Id.* at art. 84(3).

- The sale through direct agreement can be conducted only with prior approval of the creditors' committee.<sup>313</sup>
- Approval of the creditors' committee is necessary for the bankruptcy administrator/Agency to sell the entire bankruptcy debtor as one legal entity, or to sell individual plants or units.<sup>314</sup>
- If the creditors' committee objects to the draft of the main distribution, the bankruptcy panel holds a hearing to resolve the objection.<sup>315</sup>

All of these items give the creditors much more authority than is necessary or desirable in the case of a bank. The problem is that while creditors' committees may be an acceptable mechanism for dealing with bankruptcies of most kinds of commercial enterprises, they are not very well suited to banks. Creditors' committees, by definition, are comprised of individuals and representatives of creditor enterprises, each of which will, understandably, pursue its own self-interest in attempting to realize the maximum amount from the estate. Moreover, proceedings such as creditors' meetings tend to lengthen bankruptcy proceedings, which can have an adverse effect on the value of assets and destroy liquidity.<sup>316</sup> It is highly questionable, therefore, whether a creditors' committee is necessary, or even desirable, in the bank resolution context.<sup>317</sup>

Concern for creditors' rights, which under general bankruptcy/insolvency rules aim to maximize the return for creditors and to ensure their fair treatment, must be qualified in the case of banks. The principal objective of banking law is ensuring the stability of the financial sector as a whole and to prevent systemic problems. Whereas the bankruptcy administrator of an ordinary enterprise seeks to maximize assets in the interest of creditors, the foremost objective for the administrator of a failed bank is to minimize the impact of the bank failure on the banking system as a whole. In addition to ordinary debtor/creditor interests, the legal regime for bank

---

<sup>313</sup> *Id.* at art. 110(5).

<sup>314</sup> *Id.* at art. 112(1). Note, however, that under the Law on Bank Bankruptcy, sale of the bank or insurance company as a legal entity in the course of bankruptcy proceedings is prohibited in any event (*See Id.* at art. 11), which is problematic for other reasons.

<sup>315</sup> *Id.* at art. 117(2).

<sup>316</sup> *See* Hüpkes, *Bank Insolvency Resolution in Switzerland*, *supra* note 260, at 16.

<sup>317</sup> *Cf.* Swiss Banking Act, *supra* note 67, art. 35, ¶1 (creditors' assembly is used only if the liquidators appointed by the Banking Commission consider it opportune to do so), ¶ 2 (the Banking Commission can, but is not obliged to, appoint a creditors' committee).



resolution must give a high degree of consideration to the public interest. This requires a departure from the “*pari passu*” principle (equal treatment of all creditors).<sup>318</sup>

## 6. Interaction Between Court Processes: Administrative and Commercial Courts

The interaction between the provisions of the Banking Law on license revocations, on the one hand, and judicial commencement of the bankruptcy or liquidation process under the Bankruptcy and Bank Bankruptcy Laws, on the other, is troublesome.

Under the current legal regime, the process of resolving a failed bank potentially involves three separate court proceedings. When the NBS revokes a bank's license, the bank can initiate administrative proceedings to seek judicial review of that decision.<sup>319</sup> In Serbia, this currently is undertaken by a department of the Supreme Court.<sup>320</sup> This is an optional proceeding that takes place only if the bank chooses to appeal against the NBS's decision to revoke the bank's license. This process is also reflected in the Bank Bankruptcy law, which gives the bank the opportunity to seek review of the NBS' decision on

---

<sup>318</sup> Hüpkas, *Why a Special Regime*, *supra* note 260 at 12. Policy issues aside, there are some drafting problems that render the above provisions questionable. For example, the creditors committee, or any creditor affected by the actions referred to in paragraph 3 of Article 18 (regarding actions of the bankruptcy administrator) may bring an objection to the bankruptcy judge. *Id.* at art. 18(3). Likewise, the president and members of the creditors committee have a right to reimbursement of necessary expenses actually incurred, which are determined by the bankruptcy judge. *Id.* at art. 28(1). Since there is no bankruptcy judge in a proceeding involving a bank, who would make these determinations? Presumably the bankruptcy panel, but the Law does not actually state this. See discussion *supra* at Part G 4..

<sup>319</sup> Serbian Banking Law, *supra* note 1, art. 9, ¶ 5.

<sup>320</sup> Currently, the Supreme Court has a department that considers appeals from final decisions of administrative bodies. See Law on the Organization of Courts, RS Official Gazette Nos: 46/91, 60-91, 18/92, and 71/92, art. 39 (2002); Republic of Serbia Ministry of Justice and Ministry of Interior, *Policy Paper for Donor Coordination Meeting* 24 (November 18, 2003). Pursuant to amendments to the Law on the Organization of Courts (effective January 1, 2007), the Administrative Court (which was originally established in 2002) will have original jurisdiction in cases arising from decisions of administrative bodies. See *Id.* at art. 26. The Supreme Court will hear appeals from the Administrative Court's decisions. See Serbia and Montenegro Investment Climate, available at <http://www.buyusa.gov/yugoslavia/en/71.html> (last visited Mar. 11, 2007).

meeting the conditions to institute the bankruptcy process.<sup>321</sup> The court is obliged to render its decision within sixty days of receipt of the complaint.<sup>322</sup>

A second judicial review proceeding is possible if the NBS revokes a bank's license, but determines that the criteria for bankruptcy are not satisfied. According to the Bank Bankruptcy Law, the prescribed course of action in this situation is enforced liquidation.<sup>323</sup> Article 9 of the Banking Law allows the bank to seek judicial review of this decision.<sup>324</sup> Assume that the bank does initiate this procedure and loses in the Supreme Court or administrative court. Suppose further that the liquidation administrator (the Deposit Insurance Agency) later determines that the bank's assets are not sufficient to settle all creditors' claims, and that the criteria for bankruptcy are present after all and that the NBS agrees with this determination.<sup>325</sup> According to Article 5 of the Bank Bankruptcy Law, the bank has the right to challenge this decision, despite the fact that it had already lost one appeal: Article 5, after all, expressly states that the bank can seek review of the NBS's decision on *meeting the requirements to initiate bankruptcy proceedings* – it does not address a decision to revoke a license where liquidation, rather than bankruptcy, is undertaken in the first place.<sup>326</sup> When it is considered that there is no real difference between bankruptcy and liquidation – the bank is liquidated in any event – it is clear that the second proceeding is unnecessarily duplicative.<sup>327</sup>

The third proceeding, which always takes place, entails a determination by the competent court to commence the bankruptcy process.<sup>328</sup> The competent court for bankruptcy and liquidation matters is the Commercial Court.<sup>329</sup> The time period in which the NBS is required to forward its decision to the court to commence this process is not stated in the Law, but the NBS is required to render the decision on fulfillment of conditions for initiating bankruptcy proceedings over the bank immediately upon rendering the decision on revocation of the bank's operating license, or, at the latest, on the day following the day of receipt of a proposal regarding the liquidation

---

<sup>321</sup> Bank Bankruptcy Law, *supra* note 2, art. 5, ¶ 1.

<sup>322</sup> *Id.* at ¶ 2.

<sup>323</sup> *Id.* at art. 3, ¶ 2.

<sup>324</sup> See Serbian Banking Law, *supra* note 1, art. 9, ¶ 5.

<sup>325</sup> See Bank Bankruptcy Law, *supra* note 2, art. 4, ¶ 2.

<sup>326</sup> *Id.* at art. 5, ¶ 1.

<sup>327</sup> See discussion *supra* at Part G 2.

<sup>328</sup> See Bank Bankruptcy Law, *supra* note 2, art., art. 6.

<sup>329</sup> Law on the Organization of Courts, *supra* note 320, art. 24, ¶ 4.

administrator.<sup>330</sup> The court is obliged to make a decision on the bankruptcy no later than the first business day following receipt of the NBS's decision.<sup>331</sup>

These time frames are rather problematic. If the NBS files its decision with the commercial court immediately following the license revocation resolution, and the court has to render a decision within one day, there is a possibility that the commercial court could render a decision before either of the judicial review proceedings described above (assuming they have been initiated) has run its course. The commercial court could thus decide to commence the liquidation or bankruptcy process, only to have the Supreme Court (or administrative court) later cancel the NBS's resolution on license revocation or the bankruptcy determination. Depending on what stage the resolution process was in, this could require the Agency to "unscramble the eggs," by reversing a number of the steps that have already been taken. Clearly, this is not a good scenario. On the other hand, the commercial court could refuse the NBS's petition, even if the Supreme Court or administrative court ultimately rejects the bank's petition for review. In this scenario, the result would be a non-functioning "former bank" that could not be wound up. Neither of these scenarios is feasible or desirable. (Again, however, the alternative is liquidation, but this is also problematic, as the following paragraph points out).

An additional issue is the incompatibility between the two sets of proceedings. As we have seen, the NBS must, or may, revoke a bank's license in a number of circumstances.<sup>332</sup> Some of these are due to extreme financial difficulties, and some are due to other factors, such as lack of ownership transparency, fundamentally untrustworthy management, and so forth.<sup>333</sup> Bankruptcy proceedings, on the other hand, require not only that a bank's license has been revoked, but that the bank has been illiquid for fifteen days, or that its liabilities exceed its assets.<sup>334</sup> A bank not meeting one of the two latter criteria cannot be adjudged bankrupt. In this scenario, the prescribed course of action is liquidation,<sup>335</sup> but since liquidation is only one type of bankruptcy proceeding<sup>336</sup> and, thus, presumably requires a bankruptcy determination by a competent court, a defunct bank's affairs cannot be wound up without a judicial determination of bankruptcy in any event. Thus, where a

---

<sup>330</sup> Bank Bankruptcy Law, *supra* note 2, art. 4.

<sup>331</sup> *Id.* at art. 6.

<sup>332</sup> Serbian Banking Law, *supra* note 1, art. 130.

<sup>333</sup> *Id.*

<sup>334</sup> Bank Bankruptcy Law, *supra* note 2, art. 2.

<sup>335</sup> *Id.* at art. 3, ¶ 2.

<sup>336</sup> Bankruptcy Law, *supra* note 264, art. 1, ¶ 2.

de-licensed bank does not meet the bankruptcy criteria, the result could be a state of perpetual limbo.

A more synchronized approach would be helpful, which would tie the timing of the commercial court's decision on the NBS's bankruptcy petition to the Supreme Court's (or administrative court's) determination on the bank's petition for review (if any). Briefly stated, the process could work as follows:

- (1) The bank would have a short period of time (say, ten days) to file a petition for review with the Supreme Court (or administrative court as of 2007). The Supreme Court or administrative court would be required to make a decision on the petition within a specified time period after receiving it (say, thirty days).
- (2) The bank should have only one opportunity to submit a petition for judicial review, not two. The appropriate reference is Article 9 of the Banking Law. Once the NBS determines that a bank's situation is sufficiently serious that it needs to be wound up, this should be the only reviewable issue. The only question for the court should be whether or not there were legal grounds to revoke the bank's license. Once that question is answered affirmatively, the bank resolution process should commence. The bank should not be given a second opportunity, as Article 5 of the Bank Bankruptcy Law now provides, to seek judicial review of the NBS's determination that the bank fits the criteria for bankruptcy where it has already had that opportunity in connection with the license revocation/liquidation decision.
- (3) The distinction between "bankruptcy" and "liquidation" should be eliminated, as it is a distinction without a difference.<sup>337</sup> Liquidation should be simply one possible option under the "bank resolution" umbrella, along with mergers, purchase-and-assumption transactions, the creation of a bridge bank, and others.<sup>338</sup> The word "bankruptcy" does not need to be used in the case of a bank.

---

<sup>337</sup> See discussion *supra* at Part G 2.

<sup>338</sup> See discussion *infra* at Part G 10.

- (4) The NBS would not petition the commercial court to commence the resolution process until after the judicial review process had run its course (or until the expiration of the ten-day appeal period, if no petition for review is filed within that time). With a short enough time frame for the judicial review process, this should not cause undue delay. In the meantime, the bank would be under the control of a temporary administrator appointed by the NBS.
- (5) The commercial court would be required to set a date to consider the NBS's petition within a short time period (say, not later than three business days) from the day the petition is filed.

As is readily apparent, the commercial court's role should be narrow and mechanical. There is virtually no substantive role for the commercial court to perform. All the commercial court needs to do is confirm that the bank's license has indeed been revoked, and that there are no pending appeals. In short, granting the NBS's petition to commence the resolution process should be routine and automatic.

Clearly, the commercial court should not have to independently determine the existence of facts upon which the bank resolution process can be undertaken; the revocation of the bank's license by the NBS should provide the all the grounds that are necessary for this decision. The facts supporting that decision should be contained in the administrative record, and should be considered by the Supreme Court, not the commercial court.

If the bank seeks judicial review of the National Bank's license revocation decision and loses, then clearly it should not be able to present those arguments again to the commercial court. The case is even stronger if the bank does not choose to seek judicial review at all. In this scenario, the bank clearly should not have the ability to "resurrect" in the commercial court the same arguments that it could have, but did not, pursue in the Supreme Court when it had the opportunity.

## **7. Is Commercial Court Involvement Really Necessary?**

The above discussion, of course, presupposes that there is a significant role for the commercial court in the bank resolution process. However, it also raises the question of whether involvement of the court is even necessary in the first place. The above discussion points out the dangers inherent in this approach, mainly stemming from the possibility of inconsistent

decisions in the Supreme Court (on one of the bank's petitions for judicial review) and the commercial court (on the National Bank's bankruptcy filing). At the very least, the prospect of three court proceedings dealing with essentially the same substantive issue is duplicative and wasteful, even if the eventual decisions are completely consistent.

Moreover, with the commercial court's role being so routine and non-substantive, it is highly questionable whether the commercial court needs to be involved at all. Where there is no petition for judicial review on the license revocation issue (or where the bank has filed a petition and lost), there is absolutely no meaningful role for the commercial court to perform: the license has indeed been revoked, the bank has no valid reason for preventing the resolution process from going forward, and there is no good reason not to undertake that process. It does not make sense to waste the commercial court's time "rubber-stamping" the NBS's petition when there is no substantive role for it to perform.

In this author's view, Serbia would do well to adopt a purely administrative approach, under which judicial involvement would be limited to:

- review by the Supreme Court (or the Administrative Court, beginning in 2007) of the NBS's decision to revoke a bank's license, if a petition for such review is filed by the bank; and
- resolving disputes that may arise in the course of the resolution process (a function that could be carried out by either the commercial court or the administrative court).

Such an approach would make a good deal of practical sense. First, because of their limited experience in the bankruptcy area, the Serbian courts have little expertise in this field even in the case of ordinary enterprises.<sup>339</sup> Considering that resolution of banks present even more challenges than those of ordinary enterprises, the case for administration by a specialized body such as the deposit insurance agency is even stronger. Second, the vast majority of things that happen in a typical bank resolution are not inherently "judicial" and

---

<sup>339</sup> See Serbia-Montenegro Investment Climate, *supra* note 320. An additional issue is the perceived level of corruption in the Serbian commercial courts. See Moma Ilic and Dragana Nikolic-Solomon, *Anti-corruption Arrests Divide Serbia*, Anti-Corruption Gateway for Europe and Eurasia (April 2006), available at <http://www.nobribes.org/en/default.asp?ed=27&cat=4&id=1754&cid=23>.

do not require the involvement of a court. Examples include approving and reviewing ordinary (and even extraordinary) expenses, reviewing a proposed method to sell assets, approving a list of undisputed claims, disbursements, etc. Where court action is contemplated, the key questions are: 1) is it really only a *judicial* issue being decided (that is, is there a legitimate legal dispute that only a judge has the expertise to decide; and 2) does it unnecessarily stall the process?

### 8. Mergers of Problem Banks

As noted above, it is also possible for a defunct bank to be taken over by a healthy bank. Article 134 of the Banking Law allows a bank to submit to the NBS a request to assume the rights and obligations of a bank undergoing liquidation and/or bankruptcy proceedings.<sup>340</sup> This is arguably broad enough to encompass traditional methods of problem bank resolution that are now commonly used in more advanced countries, such as purchase-and-assumption transactions, or supervisor-encouraged mergers and acquisitions,<sup>341</sup> though the exact structure in Serbia raises some issues. The procedure for applying for and receiving such approval in the case of a defunct bank are identical to those that apply to mergers of healthy banks, and are found in Article 133 of the Banking Law.<sup>342</sup>

A bank that wishes to “absorb” another bank must submit a request for consent to the NBS. The bank submitting the request must amend its founding act so as to:

- (1) State the amount of its total share capital in pecuniary and non pecuniary form after the absorption, as well as each founder’s stake in share capital;
- (2) State that it is the legal successor of all the rights and obligations of the bank that is absorbed to it.<sup>343</sup>

The package of information must include:

- (1) Amendments to the founding act;
- (2) Bank’s assembly decision on the acceptance of the absorption;

---

<sup>340</sup> Serbian Banking Law, *supra* note 1, art. 134.

<sup>341</sup> See discussion *infra* at Part G 10.

<sup>342</sup> Serbian Banking Law, *supra* note 1, art. 133.

<sup>343</sup> *Id.* at art. 133.

- (3) Decision of the assembly of the bank which is absorbed to it on the absorption;
- (4) Analysis of economic justifiability of the absorption, drafted based on the most recent statements which the banks submitted to the National Bank of Serbia in compliance with Article 51 of [the Banking] Law;
- (5) Analysis that the respective absorption cannot have any negative consequences on the situation in the financial market, and/or violate competition, as specified in Article 7 of [the Banking] Law.<sup>344</sup>

The NBS may give such consent only if:

- (1) the absorption does not jeopardize financial condition of [the absorbing bank];
- (2) [the absorbing bank] has such system of organization, managing, decision making, and information technology that . . . [will] enable it to completely integrate the bank which is to be absorbed to it into its system, in a way so as not to jeopardize its functioning;
- (3) The absorption is economically justified and/or will not have negative consequences on the situation in the financial market nor does it violate [the anticompetition provisions of Article 7.]<sup>345</sup>

While the current scheme is written in a “voluntary” manner, there certainly is room for the NBS to use its powers of “moral suasion” to encourage mergers between healthy and “troubled-but-salvageable” banks.<sup>346</sup> Still, the “all or nothing” approach to assuming the rights and obligations of the target bank can have the effect of limiting options. Also, as explained below, some additional options would be helpful.

---

<sup>344</sup> *Id.*

<sup>345</sup> *Id.*

<sup>346</sup> See Margery Waxman, *A Legal Framework For Systemic Bank Restructuring* (World Bank, 1998).



## 9. Receivership and Conservatorship

The Serbian Banking Law contains a provision on receivership.<sup>347</sup> This is very different from the receivership concept in the United States, which is part of the overall bank resolution process, and is more akin to "conservatorship" or temporary management.

The NBS may introduce receivership in a bank if:

- (1) [it] establishe[s] [that the] bank is acting in breach of regulations or standards of safe and sound banking business activities, that have jeopardized its financial condition;
- (2) the bank fails to carry out [the requirements of a corrective order issued under] Article 116 of [the Banking] Law within the time period;
- (3) [the bank's] financial situation deteriorates during the period before the deadline for carrying out [an Article 116 order].<sup>348</sup>

A requirement for instituting receivership is that the NBS determines that a change in manner of management of a bank might eliminate irregularities in its business activities and improve its financial situation, and that the bodies and management of the bank cannot carry out such change.<sup>349</sup>

The receivership process entails the appointment of two official receivers, who must be persons independent of the bank and have good business reputation and adequate qualifications.<sup>350</sup> When the official receivers are appointed, the functions of the bank's board of directors and executive board are transferred to them.<sup>351</sup> The official receivers are not obliged to act according to decisions of the bank's assembly if they assess that such decisions will not contribute to the improvement of the bank's financial situation.<sup>352</sup> The official receivers may call the bank's assembly and suggest rendering of certain decisions. These decisions are submitted to the bank's assembly and have the same legal effect as decisions rendered by the bank's assembly. If the bank's assembly refuses to adopt the decisions of the official

---

<sup>347</sup> Serbian Banking Law, *supra* note 1, art. 117.

<sup>348</sup> *Id.* at ¶ 1.

<sup>349</sup> *Id.* at ¶ 2.

<sup>350</sup> *Id.* at ¶¶ 3, 4.

<sup>351</sup> *Id.* at ¶ 6.

<sup>352</sup> *Id.* at ¶ 8.

receivers, such decisions may be rendered by official receivers, with consent of the NBS.<sup>353</sup> In performing their activities, official receivers must follow instructions of the NBS, and inform it at least once a month of the business activities of the bank that is under receivership.<sup>354</sup> Official receivership may be terminated prior to the specified deadline if the official receivers or the NBS assess that the introduction of receivership has not caused an improvement of the bank's financial situation, or that the financial situation of that bank has improved so that the official receivership is no longer needed.<sup>355</sup>

The key difference between receivership in the United States and Serbia is that in the former case, the receiver completely takes over the bank and the shareholders lose their ownership rights;<sup>356</sup> in Serbia, by contrast, receivership is considered a temporary corrective measure (as evidenced by the fact that it is actually located in the general enforcement section of Chapter V of the Banking Law, on the NBS Supervisory Function, rather than in Chapter VI, on Cessation of Bank Operations). Nevertheless, the concept has considerable potential for use in the bank resolution process. In fact, the receivership process (or, more accurately, the conservatorship or temporary administration process) is actually better suited to that purpose.

First, it is highly questionable whether a supervisory authority should physically operate a bank with a view toward turning it around and returning it to the owners and managers who caused the problems in the first place. A strong argument can be made that responsibility for the safe and sound operation of a bank rests with the bank's owners, through the directors and managers appointed by them; if the bank's managers are unable, or unwilling to do this, the best course of action is to take the bank from their control and to place it with different owners and managers, or if this is not feasible, to liquidate it.

Second, using receivership as a temporary management improvement tool rather than as a step in the ultimate bank resolution process can actually impede a successful outcome. For one thing, the requirement that shareholder approval be sought for major items such as restructuring or reorganization can have the effect of delaying the process. While Article 117 does provide that the official receivers and the NBS can choose to implement proposed decisions that the shareholders reject, the fact remains that the process will be more costly and time-consuming if the shareholders must be involved. Where a bank is on the verge of failure, the requirement of full shareholder

---

<sup>353</sup> *Id.* at ¶ 9.

<sup>354</sup> *Id.* at ¶ 10.

<sup>355</sup> *Id.* at ¶ 11.

<sup>356</sup> See 12 U.S.C. §1821(d)(2)(A)(i).

participation can even make that failure more likely.<sup>357</sup> For another, this form of receivership can encourage duplicative judicial proceedings, which are time-consuming and expensive. Because it is viewed as a general enforcement function and not part of the overall bank resolution process, the bank's owners have a reasonably good argument that they should have the right to two opportunities to seek judicial review – one when the receiver is appointed, and again when the bank's license is actually revoked.

The solution to this problem that was adopted in the savings and loan context in the United States was to preclude judicial review in certain circumstances. Under this approach, the Office of Thrift Supervision (OTS) may appoint the Federal Deposit Insurance Corporation (FDIC) as either "conservator" or "receiver" for an insured savings association when certain conditions are met (and is actually required to do so if the bank becomes critically undercapitalized).<sup>358</sup> As a practical matter this has the same effect as revoking the institution's license in many other countries, although the United States does not use the "license revocation" terminology.<sup>359</sup> The grounds for appointing a conservator or receiver are identical.<sup>360</sup> The vast majority of powers of a conservator and receiver are also identical, with two main exceptions: the FDIC as receiver can actually liquidate the institution, which it cannot do when it is a conservator.<sup>361</sup> Conversely, as conservator the FDIC has the authority to take steps "to put the institution in a sound and solvent condition and preserve its assets and property," powers that are not mentioned in the receivership role.<sup>362</sup> In either case, however, the conservator or receiver takes over all of the rights and powers of the stockholders, members, directors and officers of the institution, i.e., both conservatorship and receivership wipe out the shareholders' ownership interests.<sup>363</sup>

---

<sup>357</sup> *Id.*

<sup>358</sup> See 12 U.S.C. § 1464(d)(2)(A), incorporating the conservatorship and receivership grounds of section 11(c)(5) of the Federal Deposit Insurance Act, 12 U.S.C. § 1821(c)(5).

<sup>359</sup> Conservatorship is rarely used in the United States anymore. The purpose is to buy some time for the bank supervisor while it decides on the best course of action for the bank. But much the same thing can be accomplished under receivership or with the "bridge bank" concept, which entails the initial appointment of a receiver for the defunct bank and uses the conservatorship technique only to manage the bridge bank for a limited period of time. See *infra* at Part G 10.

<sup>360</sup> 12 U.S.C. § 1821(c)(5).

<sup>361</sup> *Id.* at § 1821(d)(2)(E).

<sup>362</sup> *Id.* at § 1821(d)(2)(D).

<sup>363</sup> *Id.* at § 1821(d)(2)(A)(i) (FDIC, as conservator or receiver, succeeds by operation of law to all rights, titles, powers, and privileges of the insured depository institution for which it has been appointed, and of any stockholder, member,

After the FDIC has been appointed as conservator or receiver for an insured savings association, the institution can petition the court for judicial review of this decision.<sup>364</sup> In addition, the OTS can take a decision to replace the conservator with a receiver (again, in either case, it is the FDIC, so this is just a matter of changing the FDIC's function from that of a conservator to that of a receiver).<sup>365</sup> This decision is not subject to judicial review.<sup>366</sup> This reflects the legal and policy approach that in the United States, conservatorship is seen as simply an initial step in the overall resolution process, rather than as a more temporary enforcement measure.<sup>367</sup>

---

accountholder, depositor, officer, or director with respect to such institution). *See also* 12 U.S.C. § 1464(d)(2)(E)(ii) (FDIC as conservator or receiver for a savings association has all of the powers of a conservator or receiver under the FDIA).

<sup>364</sup> 12 U.S.C. § 1464(d)(2)(B).

<sup>365</sup> *Id.* at § 1464(d)(5)(C).

<sup>366</sup> *Id.* at § 1464(d)(5)(D). *See Franklin Savings Association v. OTS*, 35 F.3d 1466 (10<sup>th</sup> Cir. 1994).

<sup>367</sup> Strictly speaking, the described scenario applies only in the savings association context. The situation with regard to national banks and state-chartered, federally-insured banks is a bit more complicated. The FDIC may appoint itself as conservator for an institution in the latter category. 12 U.S.C. § 1821(c)(4). The institution may seek judicial review of this decision within thirty days. 12 U.S.C. § 1821(c)(7). The FDIC may replace itself as conservator with itself as receiver. 12 U.S.C. § 1821(c)(8)(A). Both the HOLA and the FDIA contain provisions limiting judicial review in this situation, but they differ slightly. The HOLA quite clearly states that except as otherwise provided, "no court may take any action *for or toward the removal of any conservator or receiver* or . . . to restrain or affect the exercise of powers or functions of a conservator or receiver." 12 U.S.C. § 1464(d)(5)(D) (emphasis added). The FDIA, on the other hand, contains a nearly identical section, but leaves out the italicized passage. *See* 12 U.S.C. § 1821(j). It could therefore be argued that a state-chartered bank can challenge the replacement of the conservator with a receiver, since the FDIA does not contain the same kind of limiting language that the HOLA does. On the other hand, both the FDIA and the HOLA give the institution the right to challenge the *appointment* of the conservator or receiver; neither gives it the right to challenge the *replacement* of a conservator with a receiver. 12 U.S.C. §§ 1821(c)(7), 1464(d)(2)(B). *See Franklin Savings*, *supra* note 366 at 1470. Moreover, both statutes specifically provide that the replacement of a conservator with a receiver does not affect the institution's right to challenge the *original* appointment of the conservator. 12 U.S.C. §§ 1464(d)(5)(C), 1821(c)(8)(C). With regard to national banks, the picture is even murkier. The Bank Conservation Act, 12 U.S.C. § 201 *et seq.* (2000) authorizes the Comptroller to appoint a conservator for a national bank on the grounds contained in the FDIA. 12 U.S.C. § 203(a). Judicial review may be sought within twenty days. 12 U.S.C. § 203(b). The Act authorizes the Comptroller to replace the conservator with another conservator, but unlike the situation with the OTS (regarding savings associations) or the FDIC (regarding state-chartered banks), does not mention replacing the conservator with a receiver. *Compare* 12 U.S.C. § 203(e) *with id.* §§ 1464(d)(5)(C)

In preparing future amendments to the Banking Law, Serbia would do well to eliminate the concept of "rehabilitation-oriented" receivership, and to focus on receivership (or conservatorship) as part of the overall bank resolution process. In essence, the focus should be on preserving the assets of the failed bank and preventing their disappearance until a solution can be determined. In so doing, it should consider adding some provisions to the existing ones.

Currently the law provides that on the day of rendering the resolution on revocation of the bank's operating license, the NBS will block all of the bank's accounts, and simultaneously declare a prohibition on disposal of the bank's property until the initiation of bankruptcy proceedings and/or liquidation.<sup>368</sup> Transactions undertaken in violation of this prohibition are considered null and void.<sup>369</sup> While these measures are clearly necessary, they are not sufficient by themselves to prevent asset dissipation. First, blocking the bank's accounts is only helpful for payments that are made through the NBS; for international payments, where the bank might use a foreign correspondent bank rather than the NBS, the blocking process is not helpful. Second, blocking the accounts will not prevent the disappearance of other kinds of assets, whose transfer is not affected by the payment mechanism. Finally, simply prohibiting property disposals is unlikely to deter anyone who is really intent on effectuating them. Even deeming the transaction to be null and void does not fully address the problem of unwinding the transaction once the money is out the door. While it might be possible to recover some or all of the funds under the law's prohibited preference provisions, it is far more efficient to prevent their occurrence in the first place.<sup>370</sup>

---

and 1821(c)(8). The Comptroller may terminate the conservatorship of a national bank upon the appointment of a receiver under the National Bank Receivership Act, 12 U.S.C. § 191. See 12 U.S.C. § 205(b). The latter statute makes no provision for judicial review of receivership appointments. Such appointments are therefore subject to review in accordance with the Administrative Procedure Act. See *James Madison Ltd., by Hecht v. Ludwig*, 82 F.3d 1085, 1094 (D.C. Cir. 1996), *cert. denied*, 519 U.S. 1077 (1997). A national bank could, therefore, make a fairly persuasive argument that the "replacement" of a conservator with a receiver really is not a "replacement" at all, but rather an "appointment" of a receiver which is subject to judicial review. While the policy issues are identical in all three cases, the statutory language is explicit only with regard to savings associations. A federal court may well decide the issue the same way in the bank context, but this issue apparently has never been adjudicated.

<sup>368</sup> Serbian Banking Law, *supra* note 1, art. 130, ¶ 5.

<sup>369</sup> *Id.* at ¶ 6.

<sup>370</sup> Additionally, while the Bankruptcy Law provides for putting temporary measures in place to preserve the debtor entity's assets before a determination is made on the bankruptcy petition, Bankruptcy Law, *supra* note 264, art. 47, this applies in the

The law should therefore provide that simultaneously with revoking the bank's license, the NBS would appoint a conservator for the bank. The conservator should take complete control of the bank and its assets.<sup>371</sup> Ideally, the Deposit Insurance Agency should be the conservator. The conservator should stay in place until a determination is made as to the most appropriate course of action for the bank (which will normally entail a purchase-and-assumption transaction, merging the bank with another bank, or, if one of these alternatives is not feasible, liquidation). Also, the conservator should remain in place until any judicial review process is complete, otherwise the possibility of asset-stripping would be enormous. The conservator should also make a complete assessment of the financial condition and future prospects of the bank, and make a recommendation to the NBS and the Deposit Insurance Agency.

Shifting the focus from "rehabilitation-oriented" receivership to a regime that is merely a step in the overall bank resolution process would also likely minimize the possibility of judicial interference in the process. As Dr. Hüpkes points out, there is a real danger that actions taken by a provisional administrator can be nullified if they run counter to shareholder wishes, unless the provisional administration is clearly structured so that it is part of the larger resolution picture. This is illustrated by the case of *Panagis Pafitis and Others v. Trapeza Kentrikis Ellados AE and Others*,<sup>372</sup> in which the European Court of Justice (ECJ) considered the applicability of the EU Second Company Law Directive to the actions of a provisional administrator that had been appointed for a bank by the Central Bank of Greece. The provisional

---

context of "preliminary proceedings," and there is a real question as to whether this concept is even applicable to banks. See discussion *supra* at Part G 4. It is true that the court is obliged to make a decision on instituting bankruptcy proceedings no later than the next business day after receiving the NBS's decision, but the problem is that financial assets can disappear in a matter of minutes.

<sup>371</sup> Compare 12 U.S.C. § 1821(d)(2). In practice, in the United States, when a federal banking agency takes over a bank, it sends a team of examiners, attorneys and other resolution-oriented personnel to the bank without any prior notice, often near the close of business on a Friday afternoon. The necessary papers are executed within minutes, and the existing senior management team is dismissed. The resolution team works through the weekend to secure the bank and inventory its assets (down to such mundane things as arranging to change the locks on the doors and to have new security passes issued to those trusted employees who are being retained). The successor bank (often a bridge bank or similar entity) then opens for business on Monday morning under the auspices of the FDIC as conservator. The bank's customers barely notice the difference. This brief summary is based on the personal experience of the author, who participated in many closings of insolvent savings and loan associations during the 1980s and 1990s.

<sup>372</sup> Case No. C-441/93 (1996).

administrator had decided on a capital increase without a decision of the general assembly of shareholders. The ECJ held that member states must not adopt bank reorganization measures that violate the minimum level of protection for shareholders, and held that any changes in the capital structure of a banking corporation without a resolution of the general meeting were contrary to Article 25(1) of the Directive. As Dr. Hüpkes notes, however, the case might well have turned out differently if the appointment of the provisional administrator had occurred in the context of formal bank resolution proceedings, which, as a general rule, entail the divestiture of the shareholders' ownership rights.<sup>373</sup>

While the current Serbian Banking Law allows official receivers appointed by the NBS to override the decisions of bank shareholders with regard to "certain decisions" (without specifying what those decisions are),<sup>374</sup> there is a real question as to whether this provision would withstand a legal challenge if Serbia were eventually to realize its EU membership ambitions. Clearly, the NBS would be in a stronger position if: 1) the grounds for instituting receivership were the same as for revoking a license; and 2) fundamental reorganization was included in the category of "certain decisions" that could be implemented without shareholder approval.

## 10. Bank Reorganizations

Currently, the reorganization concept does not apply to banks whose licenses have been revoked.<sup>375</sup> Yet, in some cases, this may be the wisest course of action. Mergers arranged by the NBS or the Deposit Insurance Agency, purchase-and-assumption transactions,<sup>376</sup> the possibility to create a

---

<sup>373</sup> Hüpkes, *Why a Special Regime*, *supra* note 260, at 21.

<sup>374</sup> Serbian Banking Law, *supra* note 1, art. 117, ¶ 9.

<sup>375</sup> Bank Bankruptcy Law, *supra* note 2, art. 19.

<sup>376</sup> See 12 U.S.C. §1821(d)(2)(G). A "Purchase and Assumption" (P&A) transaction is the most often used final solution to resolving failing banks in the United States. It is essentially a closed bank merger, in which a healthy bank agrees to assume the deposit and other liabilities of a failed bank in return for its good assets and cash or notes from the government (usually the deposit insurer). Usually healthy banks are not interested in taking over distressed assets even at heavily discounted prices. They are usually also reluctant to take over some assets that the government considers not to be distressed, at least not without some loss protection. A P&A transaction can be structured so that the public authority (again, normally the deposit insurer) agrees to provide funds to buy a failing bank's distressed and questionable assets at their estimated fair value and the government regulatory body, such as the deposit insurer, provides the assistance necessary to fill any remaining shortfall between assets and liabilities (i.e., to bring the bank's capital level up to zero). This is usually cheaper than a deposit payout via straight liquidation. See generally FEDERAL DEPOSIT INSURANCE

“bridge bank,”<sup>377</sup> selling off parts of the distressed bank, debt-for-equity swaps, and recapitalization by new or possibly existing shareholders, could all be part of the picture.<sup>378</sup>

To accomplish this in the most efficient manner, the receivership provisions should be restructured as outlined above. Two approaches are possible. First, the official receivers could take control of the bank upon revocation of the license and succeed to the ownership rights of the shareholders (as in the United States).<sup>379</sup> They would thus unquestionably have the authority to carry out a reorganization of the bank without shareholder approval.<sup>380</sup>

The alternative approach entails essentially keeping the existing structure, but amending the grounds for instituting receivership so that they are identical to those for revoking the bank’s license. In this way, there would be no question that receivership was part of the overall bank resolution process. In essence, receivership would be treated as a temporary alternative to license

---

CORPORATION, RESOLUTIONS HANDBOOK Ch. 3 (2003), *available at* <http://www.fdic.gov/bank/historical/reshandbook/index.html>.

<sup>377</sup> See 12 U.S.C. § 1821(n). A bridge bank is, essentially, a limited life, full service bank that takes over the assets and liabilities of a failed bank. The basic purpose is to provide time to structure a final solution – usually a purchase-and-assumption transaction. The bridge bank operates under the direction of the deposit insurer and provides basic and essential banking services, but operates conservatively, accepting deposits and making low-risk loans to regular customers. Its management goal is to preserve the franchise value of the bank and to minimize any disruption to the local community. Existing shareholders and other subordinated claims are left behind as claims against the failed bank’s estate. They only receive payments to the extent that any funds are left after a final resolution and repayment of any government funds. Bridge banks were developed in the U.S. in late 1980s to resolve large and complex failing banks. Early bridge banks often involved the consolidation of multiple failing banks into one bridge bank. The Office of Thrift Supervision (OTS) used a very similar concept during the savings and loan crisis in the 1980s and early 1990s. The principal difference between the true bridge bank approach, as the FDIC originally conceived it, and the OTS variation is that in the latter case, the OTS would often create a single successor institution to replace a single failed savings association. The new institution would be managed by the Resolution Trust Corporation (RTC) as conservator until a long-term solution could be found. An example of the legal documentation for creating a new federally-chartered savings association under the auspices of the OTS can be found at the official OTS website, <http://www.ots.treas.gov/docs/r.cfm?61056.pdf>.

<sup>378</sup> See Hüpkes, *Bank Insolvency Resolution in Switzerland*, *supra* note 260 at 13-15.

<sup>379</sup> See 12 U.S.C. § 1821(d)(2)(A)(i).

<sup>380</sup> See 12 U.S.C. § 1821(d)(2)(G).



revocation and liquidation, and could be used to buy some time for the NBS to work out an appropriate course of action. The official receivers could have the authority to propose reorganizations to the shareholders, as is the current practice; the difference would be that if the shareholders rejected the reorganization plan, the NBS would unquestionably have the authority to revoke the bank's license and order its liquidation.

This is essentially the approach taken in Switzerland under the 2003 amendments to the Banking Act. The new Swiss regime allows for a financial restructuring to be undertaken outside of the framework provided under general corporate law. If a bank encounters serious financial difficulties, but the Banking Commission determines that there are reasonable prospects for a reorganization of the bank, the Commission can defer revoking the bank's license and can appoint an administrator, who is charged with the development of a reorganization plan for the bank.<sup>381</sup> In the meantime, the bank's business may be continued on a reduced scale under the guidance of the administrator and the Banking Commission.<sup>382</sup> The reorganization plan can impose changes to the capital structure of the bank, and as in the United States, the law makes clear that the plan is not subject to shareholder approval.<sup>383</sup> Unlike the American approach, however, in Switzerland there is no temporary ownership of the bank by a public authority. This reflects the Swiss belief the bank supervisor should not be involved in the day-to-day business of running banks and that, therefore, bank reorganization should as a matter of principle be left to the private sector. There is also a concern that direct government involvement in the reorganization process could expose the State to significant liability risk. Finally, there is concern that direct governmental involvement could also lead to a "moral hazard" problem by creating the expectation that in case of unsuccessful management and failure to return the bank back to solvency, the government would guarantee all additional losses suffered by the creditors.<sup>384</sup> The shareholders and creditors can raise objections to the plan, and if a majority of creditors (excluding secured and certain other privileged creditors) oppose the plan, the Banking Commission orders the bank liquidated.<sup>385</sup> In the absence of this, however, in the end it is the Banking Commission, rather than the shareholders, that has the authority to decide whether to accept the plan.

---

<sup>381</sup> Swiss Banking Act, *supra* note 67, § 28, ¶ 1.

<sup>382</sup> *Id.* at ¶ 2.

<sup>383</sup> *Id.* at art. 29, ¶ 3.

<sup>384</sup> See Hüpkes, *Bank Insolvency Resolution in Switzerland*, *supra* note 260 at 13-

14.

<sup>385</sup> Swiss Banking Act, *supra* note 67, art. 29, ¶ 2, art. 30.

## V. CONCLUSION

Clearly, the NBS has learned much from the experiences of other countries, and has made a gallant effort to adopt and implement the best examples of legal provisions that have worked well in those countries. The influx and influence of foreign banks should do much to speed the development of the Serbian banking sector and encourage its integration into the wider European financial world. Many of the provisions recently adopted in the 2005 Banking Law are already being practiced by commercial banks and bank supervisors in the European Union and among members of the Basel Committee. The new Banking Law provides a golden opportunity for the NBS and Serbian banks to follow suit.

Equally plain, much remains to be accomplished. The law is only a roadmap, and the implementation task will be neither easy nor painless. This article has tried to point out some of the areas in which further work is needed. Bank corporate governance is an area that deserves much more attention, in practice if not necessarily in further legal amendments. Consolidated supervision is a new and unfamiliar area, and will need much intense focus as the NBS evaluates the situations of banks that are parts of wider corporate groups. A subset of this topic involves mixed-activity groups, which pose significant risks to banks and which the NBS cannot afford to ignore. Finally, while Serbia has made some significant improvements to its problem bank resolution regime, a number of clarifications are in order.

Even with the changes in the legal text suggested here, there will still be much to do. Bank examiners and offsite analysts will need further training and mentoring on how to implement supervision based more on judgment and critical analysis than on straightforward criteria, as was the case in the past. And, of course, the support of the judiciary will be critical. For risk-based supervision to be effective, the courts must give the bank supervisory authority a wide "margin of appreciation" to fashion policies and remedies under flexible, indefinite legal provisions such as "safety and soundness," "good business reputation," and so forth.<sup>386</sup> It remains to be seen how well the Serbian courts will react to this new legal terminology.

Finally, dealing with the financial sector is only one of the many issues with which Serbia is still forced to contend. Rebuilding from years of conflict, capturing the remaining war criminals, and resolving the status of Kosovo, are all critical to the country's future.

---

<sup>386</sup> For a detailed discussion of these issues in transition economies, see Gary A. Gegenheimer, *Judicial Review of Bank Supervisory Decisions in the Former Soviet Republics: The Case of Kyrgyzstan*, 25 ANN. REV. BANKING AND FIN. L. 295 (2006).

None of these observations, of course, should obscure the fact that Serbia has made some great strides in just a few years. The dedication and perseverance of the NBS lawyers, supervisors and senior officials during the drafting and review process was nothing short of remarkable. It was an honor and a privilege to work with them.

Nearly a decade ago, following a year as resident legal advisor to the National Bank of Kazakhstan, this author wrote: "To study the transformation of a region can be intellectually stimulating, but to actually participate in that transformation is positively exhilarating. . . . [T]he experience was at once challenging, fascinating, occasionally frustrating, humbling, and most of all, enormously rewarding."<sup>387</sup> Those emotions remain every bit as strong today as they were ten years ago.

---

<sup>387</sup> See Gary A. Gegenheimer, *Bank Regulatory Reform in the Republic of Kazakhstan*, 17 ANN. REV. BANKING L. 153, 212 (1998).



