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ICR Review
Operations Evaluation Department

Report Number : ICRR11683

1. Project Data:		Date Posted :	03/17/2004	
PROJ ID:	P074486		Appraisal	Actual
Project Name :	Private & Financial Sector Structural Adjustment Credit (PFSAC)	Project Costs (US$M)	85	85
Country:	Serbia and Montenegro	Loan/Credit (US$M)	85	85
Sector(s):	Board: PSD - Banking (50%), Other industry (50%)	Cofinancing (US$M)		
L/C Number:	C3643			
		Board Approval (FY)		2
Partners involved :		Closing Date	06/30/2003	06/30/2003

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2. Project Objectives and Components

a. Objectives

Support the governments of the Federal Republic of Yugoslavia (FRY, now known as Serbia and Montenegro), in implementing financial and enterprise sector reforms that can significantly accelerate private sector -led growth through: (i) strengthening the financial system by liquidating troubled banks and improving the environment under which banks operate; (ii) privatizing and restructuring socially-owned enterprises that crowd out private sector growth, hamper banking sector recovery, and incur significant fiscal and quasi -fiscal costs; and (iii) improving the investment climate and business enabling environment.

b. Components

Banking sector reform: Resolution of large banks and other troubled banks; improved framework for bank liquidation .
Reform of socially-owned enterprises: Tender privatization of large enterprises; auction privatization of smaller enterprises; improvement of legal and institutional framework for privatization /restructuring/liquidation of enterprises; amendment of the Enterprise Law to facilitate the privatization process; forgiving of tax arrears (as part of closing transaction); strengthening institutional framework for enterprise restructuring; mitigating the social costs of enterprise restructuring and privatization.
Bank assets and enterprise workouts: Create framework to ensure that the obligations of the Bank Rehabilitation Agency (BRA), as liquidator of banks with large exposure to enterprises scheduled to be privatized, can be fulfilled in a manner that does not adversely affect privatization objectives, and does not adversely affect the interests of creditors of banks under liquidation.
Financial sector regulatory and supervisory framework: Improve existing Law on Banks and Other Financial Institutions; review the existing law on the National Bank of Yugoslavia (NBY); introduce new prudential regulations for commercial banks; strengthen supervisory capacity of the NBY.
Business environment reform: Reduce barriers to entry by reforming business registration; eliminate cash management restrictions on business accounts.

c. Comments on Project Cost, Financing and Dates

The PFSAC was a single tranche credit of US$85 million that disbursed completely in August, 2002. PFSAC was envisioned as a framework of medium-term reforms to serve as a foundation for further reform under PFSAC II, approved in June, 2003. PFSAC was accompanied by considerable TA from the Bank and other donors.

3. Achievement of Relevant Objectives:

Banking sector reform: The capacity of BRA was strengthened substantially; BRA closed 23 banks, comprising 61% of total system assets, with the 4 largest being put into bankruptcy; BRA continued remediation of banks that had been intervened earlier, with 3 of these being merged and recapitalized.

Reform of socially-owned enterprises: In tender privatization of large enterprises, 28 firms were grouped into 6 pools, with an international investment bank contracted to facilitate the sale of each pool; 20 firms have been sold thus far, with the process ongoing under PFSAC II (under which some of the sales took place). The institutional framework for privatization was strengthened by the establishment of the Privatization Agency (PA) and the promulgation of several implementing decrees under the 2001 Privatization Law. The capacity of the PA was greatly strengthened by TA provided in support of PFSAC. In auction privatization of smaller enterprises, a pilot effort was undertaken that resulted in 9 firms sold; subsequently, the governing legislation and procedures were modified, and firms were sold at auction in much larger numbers (see sec. 4); for privatization by restructuring, 50 enterprises, assessed as unviable, were identified as candidates for restructuring. Utilizing TA provided by the Bank and other donors, the PA retained specialized consultants and proceeded to begin restructuring these firms. They will ultimately be sold either in their restructured form or they will be liquidated. Resident Advisors were retained, funded from other sources, to strengthen PA capacity in this area. Amendments to the Federal Enterprise Law were enacted that provided the legal framework for enterprise privatization, restructuring, and liquidation (however, when the federation was dissolved in early 2003, work began on a Serbian enterprise law, a condition of PFSAC II; a new Serbian Insolvency Law, incorporating international best practice, is also being prepared as a PFSAC II condition). Finally, the government implemented a program to provide support, including cash payments and retraining, for workers leaving SOEs undergoing privatization.

Bank assets and enterprise workouts: BRA, as liquidator of banks with large exposure to enterprises scheduled to be privatized, signed an MOU with the Privatization Agency (PA) that subordinated the debt owed by enterprises to bankrupt banks to the claims of other creditors of these enterprises; the Privatization Law provided for out-of-court debt restructuring of qualifying enterprises scheduled to be privatized; a decree was issued allowing enterprises to write off most tax arrears when they were privatized.

Financial sector regulatory and supervisory framework: The Law on Banks was amended, and the institutional framework for bank supervision was significantly strengthened; enhanced prudential regulations were issued regarding capital adequacy, investment limitations, liquidity, internal control and audit, and credit classification. In addition, amendments to the Law on the National Bank of Yugoslavia (NBY) were enacted by parliament, part of the program to strengthen NBY oversight capacity and tighten banks' operating requirements.

Business environment reform: The project was successful at making modest improvements in the business environment, including deregulation of foreign trade and investment, tax simplification, and modernization of labor legislation. A network of regional agencies to provide assistance to SMEs was established. The credit also supported the establishment of a regulatory framework conducive to leasing and secured financial transactions; this comprised a foundation for further progress under PFSAC II.

4. Significant Outcomes/Impacts:

- Twenty large firms were sold under tender privatization (including some under PFSAC II), considerably more progress than envisioned under PFSAC
- After the legislation and procedures governing auction privatization were modified, more than 1,000 small firms were sold by end-2003, which was also considerably greater progress than had been envisioned under PFSAC
- The authorities' decision to put into bankruptcy the four largest insolvent banks helped restore confidence in the banking system and encouraged domestic savings. The number of banks declined from 83 in late 2001 to 47 in late 2003, and total credit to the nongovernmental sector expanded from Euro 1.6 billion at end-2001 to over Euro 3 billion in November, 2003.
- As one provision of the new Law on Banks, the minimum capital requirement was increased from Euro 5 million to Euro 10 million.
- The time required to register a limited liability company in Serbia declined from 59 days to 45 days following the changes initiated by the PFSAC

5. Significant Shortcomings (including non-compliance with safeguard policies):

- The Government failed to deposit credit funds into a separate account in the name of the FRY Ministry of Finance as required by the credit, which provided access to the foreign currency proceeds instead of the Dinar equivalent as foreseen under the DCA. In addition, Euro 6 million of credit funds was used to liquidate bonds held by former depositors of a failed bank, a violation of the "negative list" prohibition on the use of credit proceeds to fund local expenditures. The Bank considered that these errors were made in good faith and did not pursue available remedies.

6. Ratings:	ICR	OED Review	Reason for Disagreement /Comments
Outcome:	Highly Satisfactory	Highly Satisfactory	The shortcoming noted in section 5 is not considered to have detracted from the highly successful outcome of the project.
Institutional Dev .:	Substantial	High	
Sustainability:	Highly Likely	Likely	Given the highly fluid situation and the potential for social unrest, a rating of "likely" is more appropriate

Bank Performance :	Satisfactory	Satisfactory	
Borrower Perf .:	Satisfactory	Satisfactory	
Quality of ICR :		Unsatisfactory	

NOTE: ICR rating values flagged with ' * ' don't comply with OP/BP 13.55, but are listed for completeness.

7. Lessons of Broad Applicability:

- **An integrated approach is critical to enterprise and financial sector reform** --The problem of debts owed by unviable firms and the weak balance sheets of banks are integrally related and is best approached in an integrated manner.
- **Efforts to provide adequate protection to those displaced by privatization and restructuring are critical to reform success** --Otherwise, social unrest and opposition have the potential to delay or derail reforms
- **The availability of extensive TA was critical to project success**

8. Assessment Recommended? ○ Yes ● No

9. Comments on Quality of ICR:

The ICR is unsatisfactory. In many instances, it fails to provide information that is important to project evaluation :

- The ICR does not describe what progress has been made in the key areas of restructuring or liquidating enterprises that were unattractive privatization candidates, nor does it provide detail on the increased capacity of government in these areas (objective 2 and para 42 of the President's Report, or PR). In terms of progress in enterprise restructuring, the ICR restates what is contained in the PR, without describing progress, if any, in the 20-month period since then.
- The PR states that specific amendments to the Law on Banks were made (e.g., definitions of ownership and equity capital, minimum capital requirement). These were core conditions of PFSAC, but the ICR does not mention them, or provide detail on improvements that may have occurred since their submission .
- The PR states that specific amendments to the Law on the National Bank of Yugoslavia (NBY) were submitted to parliament--a credit condition. These were key elements of the program to strengthen NBY oversight capacity and tighten banks' operating requirements, but the ICR does not mention them or any progress that may have occurred since their submission.
- The PR states that amendments to the Enterprise Law (intended to facilitate privatization) were submitted to Parliament--a core condition of the credit. However, the ICR does not mention them or any progress that may have occurred since their submission.