

BANKING AGENCY OF REPUBLIKA SRPSKA

INSTRUCTION

**FOR DEVELOPING AND MONITORING STRATEGY FOR TREATMENT OF NON-
PERFORMING EXPOSURES**

Banja Luka, July 2023

Instruction for developing and monitoring strategy for treatment of non-performing exposures shall be adopted pursuant to Article 5, Paragraph 1, Item b) and Article 22, Paragraph 1, Item f) of the Law on the Banking Agency of Republika Srpska ("Official Gazette of Republika Srpska, No.: 59/13 and 4/17), Article 6, Paragraph 1, Item b) and Article 22, Paragraph 4, Item m) of the Statute of the Banking Agency of Republika Srpska ("Official Gazette of Republika Srpska, No.: 63/17), and Article 11 of the Decision on credit risk management and determining expected credit losses ("Official Gazette of Republika Srpska, No.: 48/19, 109/19, 73/21 and 35/23).

Subject

Article 1

(1) This Instruction shall stipulate procedures applied when developing, implementing and monitoring strategy for treatment of non-performing exposures of a bank (hereinafter: the strategy). The Instruction provides a set of minimum requirements which the bank is obliged to use when developing the strategy, and which shall ensure a uniformed framework for all banks.

(2) Provisions of this Instruction shall be applied to banks headquartered in Republika Srpska (hereinafter: the bank) to which the Banking Agency of Republika Srpska (hereinafter: the Agency) has issued an operating license.

(3) For issues relating to the strategy development not defined by this Instruction, but defined by the law or other by-laws, the provisions of that law or a by-law shall be applied.

Strategy integral parts

Article 2

(1) Article 11, Paragraph 6 of the Decision on credit risk management and determining expected credit losses ("Official Gazette of Republika Srpska, No.: 48/19, 109/19, 73/21 and 35/23) stipulates that the bank whose share of non-performing loans in total loans is higher than 5% for three consecutive months shall be obliged to deliver to the Agency the strategy for treatment of non-performing exposures. In the Strategy, the Bank must determine strategic objectives in the form of reducing non-performing exposures by periods in real time horizon.

(2) The Strategy must contain an individual approach and the bank's objectives to achieve the required reduction of non-performing exposures by using methods and approaches at its disposal.

(3) The key integral parts of the development and implementation of the bank's strategy are as follows:

1. the assessment of business environment, internal and external conditions,
2. the development of strategy in short, medium and long term,

3. the preparation and implementation of operational plans,
4. the embedding of strategy into the bank's management system and
5. reporting to the Agency.

Assessment of business environment, internal and external conditions

Article 3

(1) The assessment of business environment, internal and external conditions should represent a basis for decision making of the bank's governing bodies on objectives to reduce non-performing exposures, also including time frame of set targets.

(2) The Bank is expected to assess and describe in detail at least the following three aspects in the Strategy:

1. internal capabilities for efficient management and reduction of non-performing exposures,
2. availability of methods for reducing non-performing exposures within the business environment and depending on external conditions and
3. impact of selected methods and approaches on the bank's capital and capital adequacy.

(3) The assessment of internal capabilities for efficient management and reduction of non-performing exposures should be based on the analysis of:

1. main causes of the occurrence and the amount of non-performing exposures (including the time-period of holding non-performing exposures in the bank's portfolio),
2. the results of applied methods and processes for management of non-performing exposures in the previous period and
3. internal capacities (processes, tools, data quality, IT/automatization, sufficient number of employees having adequate expertise and experience and similar) relating to different phases of the process itself.

(4) In terms of Paragraph 3, Item 1) of this Article, the bank is obliged to ensure that the strategy contains the analysis of inflows and outflows of non-performing exposures, i.e. analysis of the volume and trend of non-performing exposures at an appropriate level of granularity, depending on homogeneity of individual portfolios.

(5) In terms of Paragraph 3, Item 2) of this Article, the bank is obliged to ensure that the strategy contains the analysis of the results of applied methods and processes for management of non-performing exposures in the previous period, including the analysis of recovered and restructured non-performing exposures at an appropriate level of granularity.

(6) In terms of Paragraph 3, Item 3) of this Article, the bank is obliged to ensure that the strategy contains the analysis of internal capacities for efficient management and reduction of non-performing exposures, and at least should include the adequate information on:

1. capacity and professional competence of employees, in a sense whether the employees have adequate experience and knowledge in the relevant field, and appropriate training,
2. functional and adequate IT support and accounting system, which should provide the required data for the relevant analysis.

(7) In the strategy, the bank is obliged to analyze and cover (amount and trend) tangible assets acquired in the process of receivables collection (hereinafter: acquired tangible assets), where it is necessary to cover and analyze, at a sufficiently granular level, accounting, assessed and realized values of acquired tangible assets.

(8) In order to assess internal capacities relating to different process phases of management and reduction of non-performing exposures, the bank is obliged to reassess and describe at least the following:

1. early warning system which identifies potential non-performing exposures, and which includes, *inter alia*, the list of debtors that should be under enhanced supervision by the bank (Watch List),
2. resolution framework and activities,
3. framework for determining expected credit losses, as well as accounting and permanent write offs,
3. collateral value framework,
5. framework relating to recoveries, legal proceedings and acquiring assets in the process of receivables collection,
6. framework for managing acquired tangible assets if relevant for the bank and
7. reporting and monitoring of non-performing exposures which includes regulatory and public disclose in accordance with applicable laws and by-laws, and the analysis of efficiency of methods and procedures in the process of management and reduction of non-performing exposures through the monitoring procedure.

(9) Reassessing internal capacities for management and reduction of non-performing exposures should also include detailed self-assessment. The self-assessment is a part of the operational plan and the bank must conduct it at least annually.

(10) The analysis of availability of methods for reduction of non-performing exposures within the business environment and depending on internal and external conditions shall be conducted along with the assessment of internal capacities.

(11) The bank shall perform the analysis of business environment, internal and external conditions which should be directed at current environment and potential future options that should be realistic in order to select adequate methods for reduction of non-performing exposures.

(12) In order to assess the external possibilities for reduction of non-performing exposures, the bank shall reassess and describe the main components of that process, and which should include at least the following:

1. Macroeconomic conditions – in developing strategy main scenario, reliable macroeconomic forecasts and macroeconomic indicators (for example, gross domestic product, unemployment rate, growth in economy branches where high concentration of the bank non-performing exposures is present, and trend of market real estate prices taking into account collateral used for securing non-performing exposures) should be used.
2. Market expectations – in order to determine the acceptable level of non-performing exposures and coverage by expected credit losses, the bank is obliged to use external reports on non-performing exposure levels and their coverage by expected credit losses which are reliable and relevant (for example, the Agency's reports, market analysts, etc.).
3. Availability of services provided by third parties – the bank should consider the engagement of legal persons whose operations are participation in servicing non-performing exposures, which are present at the local market, as well as services provided by them, which shall be the basis for the selection of method and procedures for strategy implementation.
4. Non-performing exposure sale – the bank is obliged to take into account the possibility of non-performing exposure sale, and identify potential buyers of them at the market, in accordance with applicable laws and by-laws governing the purchase and sale of the bank placements.
5. Regulatory, legal and tax framework for efficient reduction of non-performing exposures (for example, time period required for finalization of court proceedings related to the collection of collateral used for securing non-performing exposures, costs relating to court proceedings, the assessment of tax effects relating to non-performing exposures, etc.).

(13) Strategy development should be based on the assessment of realistic collection rates, thereby using the historical collection rates of individual segments of non-performing exposures which the bank realized in the previous period.

(14) Strategy should be developed and aligned with the projected capital amounts, risk appetite framework (hereinafter: RAF), internal capital adequacy assessment process (hereinafter: ICAAP) and the bank business plan.

(15) The bank should have the capacity to determine the impact of the application of different methods and procedures within the strategy framework on the capital amount and adequacy. The bank information system should provide the bank with adjusting of different economic scenarios, in order to timely take into account potential deficiencies in the capital amount, and undertake appropriate measures.

The strategy development in short, medium and long term

Article 4

(1) The strategy should contain detailed information on methods and procedures for the strategy implementation, including qualitative and quantitative aspects of non-performing exposure treatment.

(2) The strategy development should include time-defined quantitative objectives of reduction of non-performing exposures which are based on appropriate operational plans. Objectives must be sufficiently granular to reflect selected methods for the reduction of non-performing exposures.

(3) Strategy is being adopted by the bank's supervisory board, and should be reviewed at least annually (more frequent if necessary), and updated when needed. Internal policies and procedures which include the relevant area, and adequate system of internal management represent an important role in the efficient strategy implementation.

(4) For efficient management and reduction of non-performing exposures, the bank has at its disposal great selection of methods and procedures which, inter alia, include the following:

1. Collection from the debtor's cash flow.
2. Exposure restructuring – implies an agreement with the debtor on new conditions for repayment of principal and interest.
3. Legal option – implies collection of receivables when exposure restructuring is not feasible, which most often includes:
 - 1) execution/realization of collateral, i.e. sale of movable and immovable property, by out-of-court or court proceedings in order to partially or fully collect the debt.
 - 2) enforcement in case when bankruptcy or liquidation procedure is initiated against the debtor.
4. Sale of non-performing exposures, in accordance with applicable laws and by-laws regulating the purchase and sale of the bank's placements.
5. Services provided by third parties – engagement of legal persons whose operations are participation in servicing non-performing exposures.

6. Write-off of uncollectible part of the debt – used when all options of collection by cash flows and collateral sale are exhausted, i.e. movable and immovable property, whereby the debt must be written-off in accordance with regulatory, legal, tax and accounting regulation.

7. Change in the type of exposure or collateral.

(5) Methods for strategy implementation must be combined. In accordance with determined segmentation of exposure, the bank may apply different methods for strategy implementation.

(6) If in particular cases the methods for strategy implementation cannot be applied, the bank may organize preparational activities for their usage in the future. Operational plans must be adjusted when relevant methods for strategy implementation become available.

(7) Strategy and operational plans must contain a detailed description of the usage of particular methods for strategy implementation, their shortcomings and advantages in specific cases. The bank is obliged to update strategy and operational plans in accordance with changes in internal and external environment.

(8) The bank is obliged to develop strategy objectives with regards to:

1. time horizon (short term (up to one year), mid-term (from 1 to 3 years) and long-term (longer than 3 years)),

2. granularity of non-performing exposure portfolios, depending on determined segmentation of non-performing exposures, strategy objectives must be determined both for the total portfolio of non-performing exposures, and for all individual non-performing exposure portfolios (for example, unsecured household loans, secured household loans, SME loans, loans for projected financing, agriculture sector loans, service activity loans and other), in order to ensure that all segments of non-performing exposure portfolios contribute to the reduction of non-performing exposures in the bank,

3. methods for reduction of non-performing exposures (for example, whether the collection from cash flows, collateral, sale of non-performing exposures, etc. is envisaged).

(9) Basic objectives of strategy include at least the following:

1. projected absolute and percentage change in non-performing exposures in relation to the bank's total exposures,

2. value of non-performing exposures with determined expected credit losses (net carrying value) and without determined expected credit losses (gross carrying value),

3. main segments of non-performing exposure portfolios.

Preparation and implementation of operational plans

Article 5

(1) Strategy implementation is being carried out by operational plans. The basic purpose of operational plans is to present trend of non-performing exposure items, collection and other planned volumes, as well as activities being undertaken in order to reduce non-performing exposures and inflows of new non-performing exposures.

(2) Comprehensive operational plans should contain at least the following:

1. time-defined objectives,
2. description of methods used for strategy implementation,
3. description of system of internal governance and treatment of non-performing exposures (for example, responsibility for strategy – governance responsibilities, organization of the non-performing exposure collection function, reporting lines, processes and internal guidelines and other),
4. description of inclusion of control function of risk management and internal audit in terms of analysis, monitoring and reviewing operational plans,
5. overview of employees involved in non-performing exposure management, and their professional capabilities, from the aspect of knowledge and experience,
6. information on IT support for non-performing exposure management,
7. communication plan with internal (for example, senior management, risk management function, internal audit and other) and external parties (for example, investors for purchase of non-performing exposures and other),
8. impact of selected methods and procedures on the bank's capital and capital adequacy.

(3) The bank is obliged to clearly define in operational plans the method in which the strategy will be implemented in short- and medium term.

(4) Apart from basic objectives in strategy referred to in Article 4, Paragraph 9 of this Instruction, in operational plans the bank may include additional indicators for monitoring non-performing exposures (for example, recovery rates, collection by cash flows, status of legal activities and other). Additional indicators facilitate determination of efficiency of implemented methods for conducting strategy, but at the same time may be used as additional operational objectives.

(5) The bank is obliged to define limits above which it is necessary to develop individual operational plans at the client level, separately for private individuals and legal entities. Limits are obliged to be defined in relation to average amount of exposures at the client level, separately for private individuals and legal entities, taking into account the bank's risk profile and risk appetite.

(6) Notwithstanding Paragraph 5 of this Article, in case of private individuals, the bank may develop operational plan for a larger number of clients, adhering to criteria which enable their grouping according to similar features.

(7) In case of significant deviation from operational plans, the persons involved in the implementation of operational plans are obliged to inform the bank management thereof.

Embedding strategy into the bank management system

Article 6

(1) The bank is obliged to ensure that the strategy is embedded in the bank management system at all levels.

(2) The bank is obliged to define organizational and operational diversification of roles for strategy implementation, and clearly indicate those accountable for results achieved. The bank management and senior management must be aware of the significance of achieving targeted objectives for reducing non-performing exposures, and in accordance with that an adequate system of evaluation with determined Key Performance Indicators – KPI should be established in the bank at operational and governance level.

(3) The bank's annual budget should be aligned with strategic and operational strategy objectives for reducing non-performing exposures, i.e. it should include all costs relating to the implementation of the strategy for reduction of non-performing exposures. The bank's budget should in a sufficiently detailed and clear manner describe how all fixed costs are covered by the annual budget (for example, costs of information system, HR, marketing, and other) and variable (for example, expected credit losses, and other) costs relating to the implementation of the strategy for reduction of non-performing exposures.

(4) Strategy should be fully integrated into and aligned with the risk management framework which includes:

1. ICAAP – the bank should consider quantitative and qualitative assessment of non-performing exposure trends in usual bank operations and in extraordinary situations and include the impact of the same on planning and adequacy of required capital (strategy implementation may require, for example, additional capital given the additional requirements related to determining expected credit losses).
2. RAF – indicators and limits must be aligned with the strategy objectives and approved by the relevant bank governing body.
3. Recovery plan – parts of recovery plan relating to non-performing exposures must be aligned with defined objectives of reducing non-performing exposures.

Reporting to the Agency

Article 7

(1) The bank, whose share of non-performing loans in total loans is higher than 5% three months in a row, is obliged to deliver to the Agency:

1. strategy and overview of non-performing exposure reduction (Attachment 1) within seven days after being adopted by the supervisory board, as well as upon updating.
2. operational plans by 28 February of the year to which operational plans relate, except the first operational plan, which the bank shall deliver one month after meeting the conditions referred to in Article 11, Paragraph 6 of the Decision on credit risk management and determining expected

credit losses, and which is being developed for the period starting from the moment of meeting the conditions until 31 December of that financial year,

3. report on realization of operational plans referred to in Item 2 of this Paragraph, report on non-performing exposure trends (inflows and outflows) (Attachment 2) and overview of acquired tangible assets (Attachment 3) on a quarterly basis, within 30 days from the end of quarter to which report relates.

(2) Attachments 1, 2 and 3 are an integral part of this Instruction.

Strategy assessment by the Agency

Article 8

(1) The Agency shall monitor, review and assess the bank's strategy implementation, at an overall level, as well as by analysis of reference values, in order to ensure comparability and credibility of the bank's objectives in terms of reducing non-performing exposures.

(2) The overview of strategy, objectives and strategy implementation is also a part of the Supervisory Review and Evaluation Process – SREP and represents an interactive process between the bank and the Agency.

Coming into force

Article 9

(1) This Instruction shall come into force on the day of its adoption and shall be published on the Agency's official webpage.

(2) The bank is obliged to update the existing strategy in accordance with the provisions of this Instruction and deliver updated enactments to the Agency no later than 31 December 2023.

Number: D-15/23

Date: 27 July 2023

Director

[duly signed and sealed]

Srđan Šuput

