Report from the Republic of Serbia

Introduction

Expectations of the government and participants in the market at the start of 2011 were directed towards continuing the economic recovery begun in 2010. However, the optimism was replaced by doubts whether the initial recovery could be maintained after the renewed sovereign debt crisis in the Euro zone in mid-2011. Supported by a negative sentiment in the Euro zone and the intention to keep macroeconomic stability, the government decided to renew the arrangement with the International Monetary Fund (IMF) and this way to prevent possible negative expectations by the investors.

However, the structured misbalance between agreed payment terms and the actual time of payment, helped boost factoring business in 2011 to turnover in the amount of EUR 767 mio. The liquidity problem is becoming the top issue for many companies, large corporates, as well as SMEs.

Industry Environment [1]

Although, after the recovery cycle in 2010, the economy turned into the growth phase in 2011, the government decided to keep the programme of measures to mitigate the negative effects of the economic crisis in 2011 as well. Of course, the allocated funds were significantly reduced, from RSD 93.5 billion in 2010 to RSD 71 billion in 2011, due to the fiscal burdening of the state budget, but also due to good results achieved in the preceding period.
The programme's funds were allocated for stimulating certain industries in the value of two billion dinars (wagon construction, manufacture of tractors, buses, trucks, construction machinery, etc), as well as the continuation of the programme of interest rates subventions on liquidity loans (RSD 1.4 billion), investment loans (RSD 700 million), loans for the purchase of newly built housing facilities with the aim of stimulating the construction industry (RSD 1.6 billion) and loans for certain consumer goods (RSD 1.4 billion). The funds set aside within this programme were spent already by July 2011, and the banks placed EUR 854 million of loans to the corporate sector for investments and liquidity, as well as consumer loans.
Subvention on liquidity loans has hade a big impact on factoring business as a direct substitute, offering loans with very favourable terms, which could not be followed by the factoring industry.

Apart from the support programme to the economy, the government decided to additionally protect itself against external risks that grew in mid-2011, due to tensions on the debt market in the Eurozone, by signing a new arrangement with the IMF. Namely, after the Stand-By Arrangement (SBA) with the IMF expired in April 2011, the government began negotiations regarding a new arrangement, all with the aim of further improving the investment climate. The new contract was signed in September 2011 for the

[1] Macroeconomic analyses by Raiffeisen Research

period of 18 months and in the value of EUR 1.1 billion. By its nature, it is a precautionary arrangement. By targeting several key segments, the new arrangement focused on strengthening the system of fiscal responsibility, improving the budgeting process and improving public debt management.

One of the postulates of the new arrangement is also to continue the dinarization strategy, i.e. reducing the participation of foreign currency and foreign currency-indexed loans and deposits in total loans/deposits, with the aim of strengthening the efficiency of the monetary policy and reducing the foreign currency risk. It was a clear signal for the banks to offer factoring in larger portion linked to local currency. Furthermore the country's risk premium, measured by the EMBIG index, had a rather volatile trend, moving in the course of 2011 in the range of 349 basic points to 717 basic points, finishing the year on the level of 601 basic points. Such country's premium effected refinancing cost on FCY by high break-even for FCY funds, confirming local currency as a better source of funding.

In the first half of 2011, the high inflation rates on the annual level reached their maximum in April 2011(+14.7% y-o-y). Such high growth rates were backed by the rise in food prices due to the bad agricultural season in 2010, the growth of prices of primary agricultural produce on the world food market, but also partly by there being restricted competition in this market. Also, the growth of prices regulated by the government exceeded the agreed framework for 2011 (7% +/-2%) already in June, reaching a level of 9.1% y-o-y. However, the inflation trend changed already in the summer months due to the excellent agricultural season. The weakening of inflatory pressures continued until the end of the year, backed by the slowing down of economy growth and reduced aggregate demand, so that the inflation finished at the level of 7.0% y-o-y in 2011, slightly above the corridor set for 2011 (4.5% +/-1.5%). In accordance with inflationary movements, the NBS adjusted the monetary policy direction. So, up to May 2011, the NBS led a restrictive monetary policy by raising the key interest rate, and with the aim of returning inflation to the targeted corridor. The key interest rate reached its peak of 12.5% and the NBS started applying the moderately expansive policy with the weakening of inflationary pressures. During 2011, the NBS used only the basic instrument of monetary policy, the key interest rate that was reduced six times at a level of 9.75% at the end of 2011, which made financing in local currency more attractive for the customers.

The government's measures of support to the economy by way of a loan subvention programme, together with economy growth up to the first half of 2011, supported the growth of the banks' crediting activities in the same period. However, as a result of the crisis spillover from the EU, the credit activities in the country begin to slow down gradually, while there is an increase of placing liquidity into treasury bills of the Ministry of Finance and repo transactions of the NBS. As a result, the banks placed a total of EUR 1.4 billion of new credits in 2011 (2010: EUR 2.1 billion), of which private individuals account for EUR 749 million (2010: 637million) and the corporate sector for EUR 448 million (2010: EUR 1.3 million). The growth of the new

volume of banks' credit activity in 2011 was financed from deposits (EUR +1.2 billion), while the deposit growth in 2010 amounted to EUR 458 million. As a result of reduced liquidity in the economy, the deposit activity in 2011 was mostly generated from retail deposits (EUR +768 million), then from the corporate sector (EUR +491 million). Retail deposits reached the peak of EUR 7.6 billion in 2011.
In 2011, the NBS adopted a package of measures with the aim of introducing rules for calculating capital adequacy of banks and risk management in accordance with Basel II standards.

Apart from the worse economic sentiment both in the country and in the Eurozone, the growth of NPLs (loans more than 90 days behind payment) also influenced the banks and factoring companies to tighten their loan policies. NPLs reached a level of 18.8% in September 2011 (2010: 16.9%). The biggest growth was realized by the ratio of NPLs approved to the corporate segment, reaching a level of 24.4% in September 2011 (2010: 21.8%), while the ratio of NPLs with private individuals had a much weaker growth, reaching a level of 9.5% (2010: 8.8%). Analysed by industry, the NPL ratio in the corporate sector in September 2011 in relation to the end of 2010 mostly rose in the real estate business to 32.4% (+9.0 percentage points) and construction to 27.8% (+8.8 percentage points), while the agricultural sector marked a slump to 30.9% (-5.9 percentage points). However, although the NPL ratio is rising, the coverage of NPLs with the calculated mandatory reserve for estimated balance sheet losses was at a very high level and amounted to 128.2% in September 2011 (2010: 133.6%). Also, capital adequacy was at a very high level of 19.7% in September 2011 (2010: 19.9%).

The factoring industry was exempt from all this, expressing from the very beginnig an aversion towards real estate and construction business as well as agroculture. Having good performance of NPLs factoring as a product attract more banks as additional option for servicing the clients (data received from banks only).

Market Performance and Supply

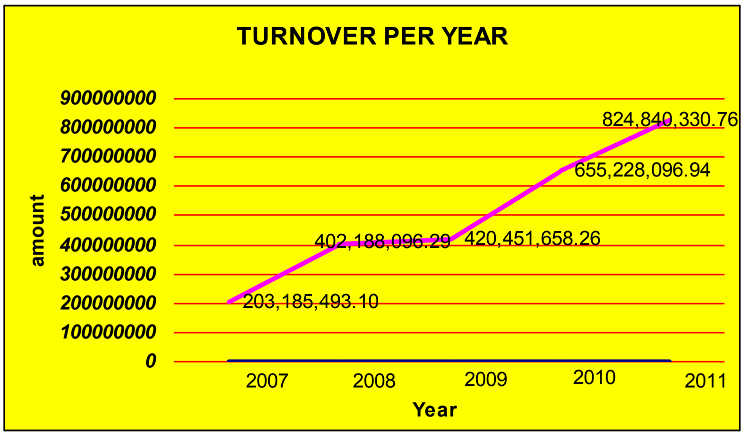
The liquidity gap, mainly generated by the biggest retail chains and public companies, still represents a major problem for Serbian corporates and SMEs.

Liquidity problems of corporates and SMEs provoked public debates concerning relevant measures that should be taken. One of the solutions was found in the bylaw, by which differed payment will be limited to 60 days from the delivery date. This option, even though this bylaw has not been enforced so far, opens the door to reverse factoring.
On the other hand, IFC recommended to the government to bring a Factoring Law, by which will regulate this area in the proper manner. Our Committee,

headed by the Belgrade Chamber of Commerce, is very active in drafting the Factoring Law, with the aim of supporting industry practices and needs.

The factoring business is increasing sharply boosting by macroeconomic situation and large front of "word of mouth" marketing offering by many factoring companies and banks.

Chart 1: TO IN SERBIA in EUR in the last 5 years

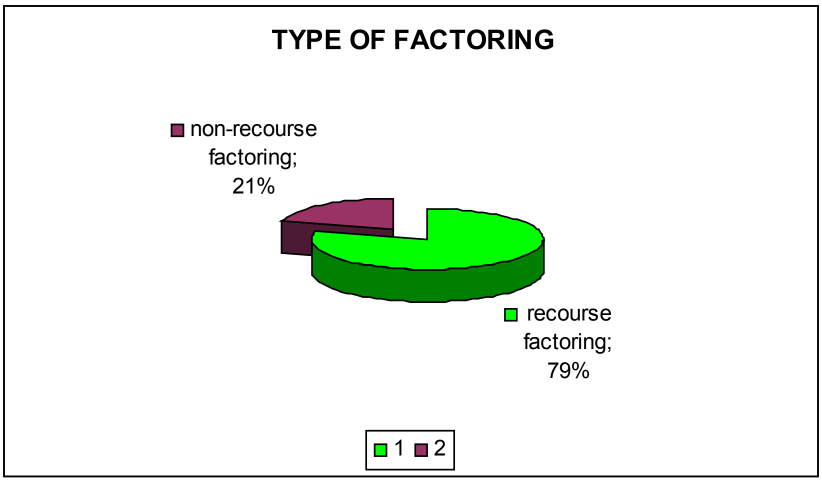


Source: Belgrade Chamber of Commerce

Constant increment confirms that the Serbian market has potential. It represents at the same time the affirmation of factoring as a special service. Having in mind that this growth is achieved in times of financial crisis, under very restrictive credit policy implemented by many of the factors, we could conclude that the affirmation of factoring is even more progressive, which is a very positive signal for the future.

Domestic factoring with recourse is still the dominant form of factoring in Serbia, which is a caracteristic of all developing factoring industries.

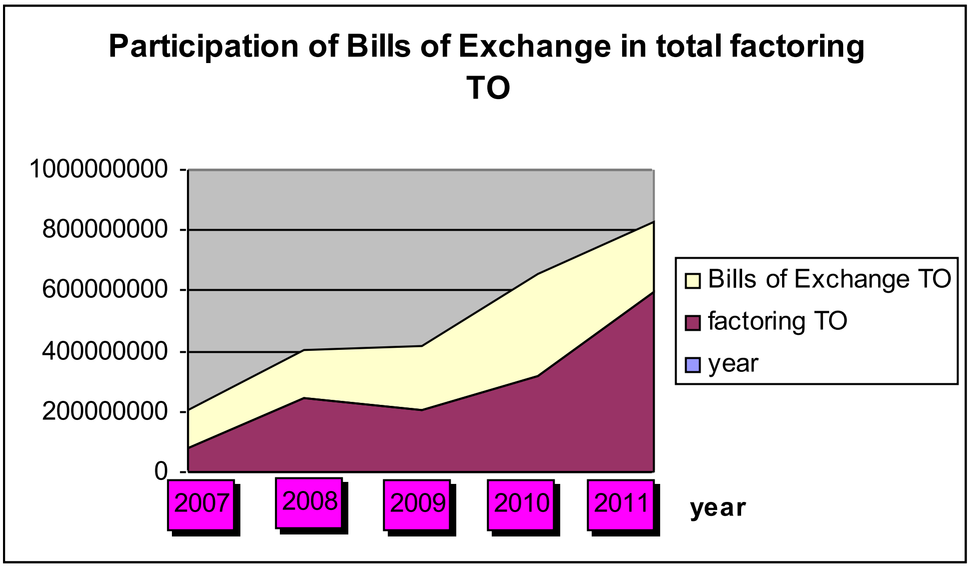
Chart 2 Factoring products



Source: Belgrade Chamber of Commerce

Participation of Bills Exchange Discounting is less and less from year-to-year, which slowly but surely confirms factoring as the first option for providing liquidity funds.

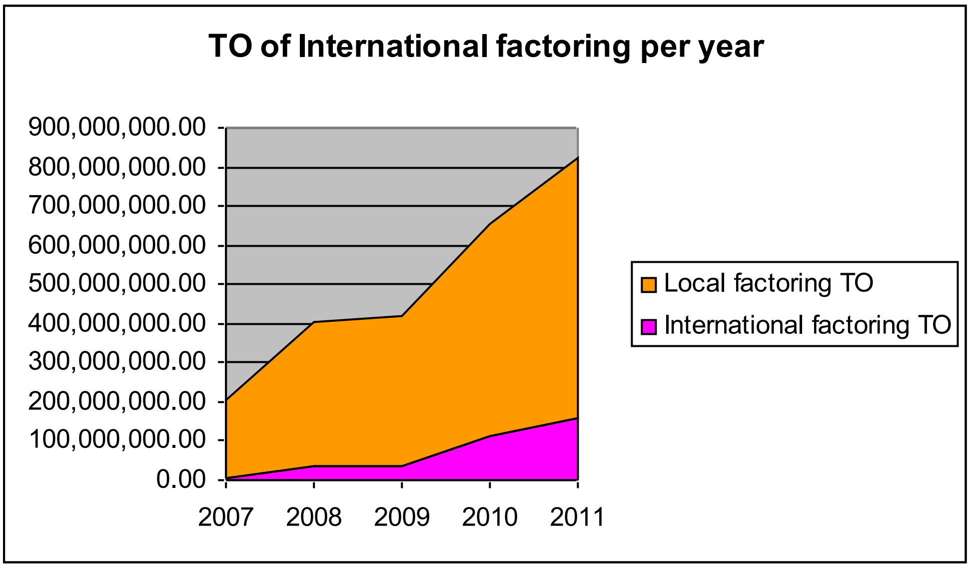
Chart 3 Product Structure



Source: Belgrade Chamber of Commerce

International factoring is the second represented product, still in development. We expect that the new Factoring Law will strongly support the two factors system and facilitate direct international factoring.

Chart 4 TO of international factoring per year



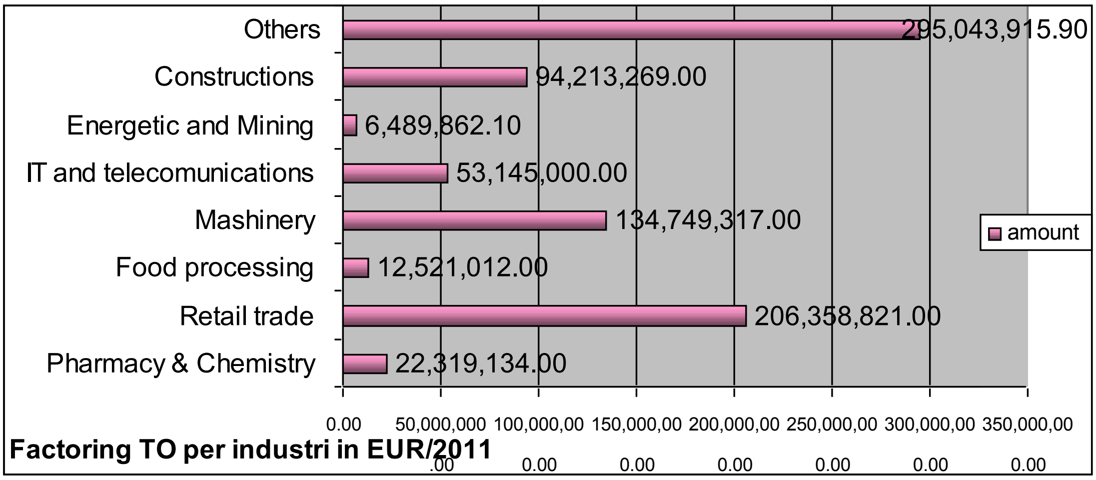
Source: Belgrade Chamber of Commerce

The typical fee structure/price structure, according to factors, is as follows:

- Arrangement fee (fee for approval of credit limit calculated once per year on approved limit-characteristic of the banks)
- Factoring fee
- Discounting interest rate

Structure of clients/suppliers per industry is made based on information provided by factors.

Chart 5 Industry Structure



Source: Belgrade Chamber of Commerce

The Chamber of Commerce reports that there are 22 factors (factoring companies and banks) operating in the Serbian market, with a trend of further spreading, especially among banks. According to a research by the Chamber of Commerce, only 13 factors are very active in all activities, as well as in reporting their turnover.

The list of factoring companies/banks with active participation is as follows (in alphabetic order):

1. A faktor d.o.o.
2. AOFI (Export Credit and Insurance Agency of Republic of Serbia j.s.c)
3. Banka Intesa a.d.
4. EFG Eurobank ad
5. Finera faktoring d.o.o.
6. JUBMES banka ad
7. Gemiko factoring d.o.o.
8. Komercijalna banka ad
9. Marfin factors & forfaiters d.o.o
10. OTP banka a.d.
11. Prvi faktor d.o.o.
12. Raiffeisen banka a.d.
13. Societe Generale banka Srbija a.d.

Future Trends

Factoring is a relatively new product, that was developing in the course of the past several years in Serbia without the relevant legal framework, lacking defined rules and experience.

The reason for this is the insufficiently developed institutional system, along with the economic environment. This is reflected, on the one hand, in the legal system of the country – i.e, the inadequately defined legal institutions that would, in a proper manner and in a short time period, prevent moral hazard, as opposed to complying to standard obligations, and on the other, by insufficient support for the development of competition in certain areas, all of which brought about the emergence of oligopoly in the market.

As regards factoring business operations in domestic banks, at this moment no particular conditions are foreseen, nor are there particular stipulations on conditions for establishing factoring companies as independent entities (capital amount, etc), including those relating to banks as founders.

By adopting a Law that would regulate factoring, the following positive effects would be achieved:

- the percentage of liabilities paid would be higher;
- liquidity would be higher, i.e. the solvency of the economy;
- legal certainty would be higher, which would have a direct influence on investments, including foreign investments;
- the business credibility of legal subjects would be higher, as well as their competitiveness;
- the indebtedness of legal subjects would be reduced;
- in the long term, employment would rise, as well as public revenue.

The market for well-known domestic creditworthy buyers in Serbia is expanding and growing stronger. In the previous years, the Serbian economy went through a difficult business period, while the above mentioned countries from the transition group went through the processes that await Serbia only in the near future.

Table 1 SWOT analysis

S: Further growth potential	W: - Lack of relevant regulations - Business environment
O: - Undeveloped market inovations - Further diferentiation of services	T: - Lack of relevant regulations, implementation of inadequate rules

Since Serbia is lagging behind in developmental phases of the transition, it is realistic to expect that Serbia's aspirations in realizing similar results be possible only in a few years' time. Yet, Serbia does have developmental potential, which is shown in the positive GDP growth trend.