Letter of Intent

Sarajevo and Banja Luka, Bosnia and Herzegovina

June 30, 2016

Ms. Christine Lagarde
Managing Director
International Monetary Fund
Washington, D.C. 20431

Dear Ms. Lagarde:

1. After several starts and stops since the global financial crisis, the economy of Bosnia and Herzegovina (BiH) is showing firmer signs of recovery. It also proved more resilient to the impact of the 2014 floods than initially expected. Growth exceeded 1 percent in 2014 and is estimated to have reached 3.2 percent in 2015. It is expected to remain at similar level, at 3.0 percent, this year.

2. Moreover, external and internal imbalances have been gradually reduced in recent years, mainly through fiscal consolidation and some progress in structural reforms. With the exception of the difficult circumstances because of floods in 2014, the consolidated budget deficit was gradually brought down in recent years by containing current expenditures and improving revenue collection. Financing constraints in 2015 caused a stronger-than-expected fiscal consolidation. The current account deficit has also narrowed. Inflation has remained low, largely reflecting low Euro area inflation imported through the currency board arrangement (CBA). The financial sector remained resilient following the global financial crisis.

3. However, the recovery remains fragile and significant vulnerabilities remain. BiH lags regional peers in income convergence to advanced European economies, with per capita incomes averaging less than third of the average income level in European economies, and income convergence has stalled in recent years. More importantly, unemployment is stubbornly high, and high youth and long-term unemployment are particularly worrisome. Low private investment has slowed private sector job creation and potential output growth. This reflects not only the lingering effect of the global financial crisis, but also a still unfinished structural reform agenda.

4. The BiH Council of Ministers (CoM) and the governments of the Federation of Bosnia and Herzegovina (FBiH) and the Republika Srpska (RS) that came to office following the general elections in October 2014 recognized the need to step up the pace of economic reforms to accelerate economic growth and create jobs, and to improve living standards of the people of BiH. Together, and in cooperation with the international community, we have adopted a broad-based Reform Agenda and developed Action Plans for Implementation of the Reform Agenda (adopted in September and October 2015). This Reform Agenda sets out the main plans of the CoM and the entity governments for socio-economic reforms in the coming years. It aims to: foster sustainable, efficient, and steady economic
growth; create jobs; increase and better target social assistance; and create a favorable economic environment. Efforts to ensure fiscal and financial sustainability will be augmented by measures to strengthen the rule of law and the fight against corruption, and to strengthen administrative capabilities and increase the efficiency of public institutions at all levels of government. We are confident that steadfast implementation of the Reform Agenda will help us on the road toward accession to the European Union (EU).

5. In this context, we request the support from the International Monetary Fund (IMF) to assist us with the implementation of our economic policies and reforms and help cover the financing needs that are projected for the coming years. In light of the need for deep structural reforms, we request a three-year extended arrangement under the Extended Fund Facility (EFF) in an amount equivalent to SDR 443.042 million (262 percent of quota). The arrangement will build upon the progress made under the SBA that expired in June 2015 and will continue to provide a valuable anchor for our economic policies and reforms. While no further reviews could be completed under the last SBA after mid-2014, fiscal and financial policies remained broadly anchored by the previous program. We also expect the new arrangement to play a catalytic role in mobilizing international support and our other international partners, notably the EU and the World Bank, are planning to provide additional funds to help ensure that the proposed program is fully financed.

6. This Letter of Intent sets out our economic policies for 2016–2019. We will implement the policies mentioned in this Letter in line with the constitutional competencies of the BiH CoM and the governments of the FBiH and the RS and their agencies and institutions. Our economic policies have three main objectives:

- First, intensifying reforms to improve the business environment to attract investment, create more private sector jobs, and raise the economy’s growth potential;
- Second, continuing the fiscal consolidation to place public debt to GDP ratio on a steady downward path, while lowering the size of government and improving the quality of government spending;
- Third, safeguarding financial sector stability and reviving bank lending.

7. In the period ahead we will reorient government expenditure by reducing current spending to make room for much needed increase in capital expenditure that is more conducive to economic growth. The current account deficit is projected to improve after 2017, and over the medium term, as exports increase, while inflation is expected to pick up to a low positive rate in line with developments in Europe. With the sustained implementation of our economic policies and reforms, GDP growth is expected to increase to 4 percent over the medium-term.

**Structural reforms to boost economic growth and job creation**

8. The objectives of raising growth and reducing unemployment will require significant improvement to the business environment and the functioning of the labor market. Some important progress has been made in the last two years, including through a number of key measures that were implemented in recent months.
9. To enhance the functioning of the labor market, the entity parliaments have adopted new entity labor laws in line with the Reform Agenda and in consultation with the IMF staff, World Bank and social partners. New collective bargaining agreements are being negotiated to agree on new employment conditions consistent with the new laws. In addition, these new laws will be supported by stepped-up labor inspections, while we will also aim to strengthen the system of unemployment benefits and active labor market policies, including by expanding training and education opportunities.

10. We will restart the privatization process in the FBiH, to help improve economic governance and competition, and reduce the risks to public finances. We have classified state-owned enterprises and public companies into those that are strategic, those requiring minor or major restructuring, and companies in which the government holds a minority share (The World Bank Group is supporting this work in FBiH). We will dispose of our minority shares in Bosnalijek and Sarajevo Osiguranje by end-September 2016. We are also conducting operational and financial restructuring of Fabrika Duhana Sarajevo and Aluminum Mostar with a view of completing their sales by end-March 2017. Other companies, such as Energoinvest and Energopetrol will require more comprehensive restructuring prior to their full rehabilitation and sale by end-December 2017. In line with the FBiH Privatization Agency plan we will address the status of the remaining state-owned enterprises and public companies either through the restructuring and possible privatization of viable enterprises or the bankruptcy/liquidation of those enterprises judged to be not viable. As part of this process, the FBiH government, in consultation with the World Bank Group and/or EBRD, will complete the financial and operational due diligence for BH Telecom and HT Mostar by end-October 2016 (structural benchmark), and will discuss the possibilities and modalities of increasing the profitability of these companies either through improving their corporate governance or selling of shares. The entity governments will adopt restructuring plans for the entity railways, with assistance from the World Bank, by end-December 2016 (structural benchmarks), and the FBiH government will also adopt a restructuring plan for public companies in the power and gas sector and coal mines during 2017. The restructuring plans will be based on increased efficiency, cost savings, and tariff levels that are sufficient to provide full cost recovery and sustainable commercial operations.

11. We will reduce the administrative burden on businesses, with a particular emphasis on harmonizing regulations between the entities. In this context, with assistance from USAID, we will review para-fiscal fees at all levels of government and the entity governments and the CoM will develop plans by [end-December 2016] with a view to lowering these. As part of this effort, we will eliminate the solidarity contribution in the RS and [the special contribution against natural disasters] in the FBiH by end-December 2016. The RS parliament has approved a new bankruptcy law in February 2016. The FBiH government has started to reform its commercial dispute resolution framework, including by adopting new FBiH bankruptcy legislation by end-September 2016 developed with the assistance of the World Bank. In addition we will enhance the court system by conducting a feasibility study with the assistance of the World Bank on whether the FBiH should establish specialized commercial courts by end-September 2016, and improved their functioning in the RS to speed up the processing of commercial and labor disputes by end-June, 2016. The amendments to the FBiH Law on Internal Trade—will be adopted [by end-December 2016], and we aim to [promptly] resolve remaining trade issues with the EU. In consultation with the World Bank, we will enhance the business regulations, including introduction of one-stop-shop solution for company registration in FBiH with a view to establish on-line registration in both FBiH and RS, aligning the process across the entities.
Making government finances sustainable and more efficient

Fiscal policies

12. There was strong fiscal consolidation in 2015 with an overall deficit of 0.1 percent of GDP, largely because of expenditure compression. We have adopted budgets for 2016 for the Institutions of BiH and the central governments of the FBiH and the RS that are consistent with the overall deficit of 0.9 percent of GDP in 2016. We are committed to reduce the overall deficit to below 0.3 percent of GDP by the time of the end of the program in 2019, with a view to reducing public debt gradually to below 40 percent of GDP over the medium term.

13. To make this fiscal consolidation sustainable, we are committed to implementing comprehensive fiscal reforms to improve revenue collection, reduce the size of government, improve the efficiency of public finances, and trim current non-priority spending to create room for investment in infrastructure.

Improving efficiency of revenue collection

14. We will continue to strengthen revenue collection and administration. In particular:

- We have expanded the exchange of taxpayer information among the four tax agencies (the Indirect Taxation Authority (ITA), the FBiH Tax Administration (FTA), the RS Tax Administration (RSTA), and the Brcko District Tax Administration (BDTA)). In 2014, we completed the process to ensure that each of the tax agencies had electronic access to taxpayer specific information in the other agencies. In order to strengthen capacity to detect taxpayer compliance risks, we have now implemented in line with IMF staff recommendation automated electronic bulk exchange of tax and social security contribution (ssc) returns, assessment, refund, cash registry, registration, audit, arrears and customs transaction data between the four tax administrations and commenced with exchanging data for 2015, and provided the tax administrations electronically with comprehensive company information from the entity business information agencies (AFIP/FIA and APIF) for the most recent year for which data are electronically available (prior action). Each tax agency will continue to share its updated bulk data once per month and APIF and FIA will also provide monthly updates.

- The ITA established a unit for the detection and prevention of VAT fraud and has started implementing a risk-based approach to audits and inspections, one of the key elements of our strategy to strengthen the control of VAT refunds and credits. Currently, about 30 percent of ITA audits are based on risk-assessments and our goal is to increase this share further. The FTA and the RSTA will also aim to advance the application of a risk-based approach in their compliance activities, with assistance of the IMF staff, utilizing where appropriate the combined and fully searchable database of taxpayer information.

- The ITA has stepped up its efforts to collect tax arrears, by actively engaging the largest tax debtors. For those largest tax debtors with whom no agreement has been reached, the ITA has referred their cases to the state prosecutor’s office, which is expected to pursue all options available under domestic law to enforce collection. The ITA will continue these efforts going forward and publish the results on its website. Meanwhile, the ITA will also continue to publish on its website monthly information about the largest tax debtors and the stock of indirect tax
arrears, and publish additional flow data on the accumulation of new tax debts, repayments, and reschedulings as agreed with the IMF staff [by September 2016]. The FTA and RSTA will also step up efforts to collect outstanding tax debts, including focusing collection activities on new tax debts, establishing payment plans with viable businesses concerning older debts, pursuing all legal options to enforce collection, and publication of the list of largest tax debtors. The FTA will work closely with the FBiH government to address the issue of the unpaid contributions (see below).

- We will adjust the allocation coefficient for indirect taxes on a quarterly basis and settle the claims semi-annually, starting on September 30, 2016 (quarterly structural benchmark). We will review, with the assistance of the IMF staff, the system for revenue allocation of indirect taxes among the various levels of government—including within entities—with a view to simplifying it and making it more automatic. The new automatic allocation system for ITA revenues in line with IMF staff recommendations will be put in place by end-December, 2016 (structural benchmark).

15. We will improve the efficiency of our tax systems. In particular:

- We are committed to preserving the integrity of the system of indirect taxation, in order to ensure the continued high level of budget revenues are delivered by indirect taxes. Indicative targets for gross indirect tax revenue collection have been set.

- The entities will harmonize their corporate income tax laws to foster consistency, avoid double taxation between the entities, reduce tax incentives and clarify the tax treatment of loan loss provisioning. The FBiH parliament has adopted a new Corporate Income Tax Law—developed with the assistance of the IMF staff—that eliminates exemptions for exporters while increasing incentives for investment, and clarifies the tax treatment of depreciation and banks’ loan loss provisioning (the law became effective as of January 1, 2016). The RS parliament will adopt amendments to the corporate income tax law consistent with IMF staff recommendation by end-December 2016 (structural benchmark) to become effective in January 1, 2017.

- To facilitate job creation in the private sector we aim to shift the tax burden away from labor by reducing the social security contribution rates in the two entities. Both entities will prepare comprehensive plans – with assistance from IMF staff – to reduce social security contributions rates and simplify and improve the efficiency of the Personal Income Tax by [end-September, 2016], to become effective in January 1, 2017. We will ensure that lowering the social security contributions rates will be deficit neutral in order not to undermine the sustainability of the social funds. The reduction in the social contribution rates will be accompanied by expanding the tax base for labor income by taxing all sources of work-related income, in particular allowances. We also recognize that this will need to be supported by improved tax administration that increases compliance. However, if sustained implementation of these measures does not prove to be sufficient to ensure the sustainability of the social insurance funds, we will take additional fiscal measures, in consultation with IMF staff, to raise additional revenues and/or implement spending cuts if needed.

- To achieve better targeting of agricultural subsidies, the RS [has made] the necessary legal and administrative changes to condition the eligibility of farmers for agricultural subsidies on their
registration and payment of social security contributions. The registration of commercial farms in accordance with the rulebook on classification of household farms into commercial and non-commercial farms is proceeding, with 14.6 percent of household farms registered as commercial as of end April 2016. During the course of 2016 agricultural subsidies will only be paid to those farmers that register and remain current on their social security contribution payments. As a result of this measure we aim to achieve a saving of 5 million KM in agricultural subsidies and an increase of 10 KM in social security contribution revenues in 2016 compared to the last year, that will help our fiscal consolidation efforts.

- To help mobilize resources for investment in essential infrastructure the BiH parliament will approve a raise in excise rates on fuel products, including LPG and biofuel by 15 pfennig per liter and channel the additional revenues from 10 pfennig of this increase to the entity highway funds and from 5 pfennig to the entity road funds, by end-September 2016. In parallel, we will increase the excise on heating oil to close the price gap between different categories of oil derivatives.

**Strengthening public finances**

16. On the expenditure side, we will streamline and increase the efficiency of government operations while also aiming to reduce the size of the government over the medium term. Thus:

- We will implement public sector reform, with the assistance of the World Bank. These reforms will allow us to introduce greater flexibility in working arrangements and help reduce the number of public sector employees while improving efficiency. The BiH CoM and the entity governments have adopted strategic plans to restrain wages (by refraining from increases in the wage base, the wage coefficients, and allowances) and reduce overall employment in the public sector over the course of the program, beginning in 2017 (*a prior action*). The entity governments and the BiH CoM will develop registries of public employment that include staff employed in the cantons, municipalities, health institutes, and extra-budgetary funds with assistance of the World Bank. This registry and a scoping note prepared by the World Bank will serve as basis for operationalizing the strategic plans on reducing public sector employment. The BiH CoM and the entity governments will adopt operational plans to reduce overall employment in the public sector based on the registries developed with the assistance of the World Bank by end-June 2017 (*structural benchmarks*). In the meantime, adherence to the wage moratorium, including refraining from increases in the wage base, the wage coefficients, and allowances, will be a continuous structural benchmark. In addition, quarterly indicative targets for current spending of the Institutions of BiH and the entity central governments have been set.

- We have initiated health care reform with assistance from the World Bank to make the health care system in the two entities sustainable, and to improve quality and equity of health services. The reforms will include addressing the debts of the health sector, defining new financing models and sources, strengthening financial accountability, controls, and management of health facilities, along with standardization of the health care institutions network. To finance health care reform the BiH parliament will approve the raise in excises on alcohol including all alcohol products to channel revenues to the health funds by end-September 2016.

- The FBiH parliament will adopt the Law on Pension and Disability Insurance (PIO) and the Law on the Organization of the PIO Fund in [October 2016] in line with World Bank recommendations to
help ensure the sustainability of the pension system, including by increasing the number of contributors, raising the effective retirement age, and broadening the base for contributions. Simultaneously, the FBiH [has drafted] legislation, also in line with World Bank recommendations, to address the issue of unpaid pension contributions, mainly accumulated by state-owned enterprises and public companies, and has ensured that the two sets of legislation are internally consistent. The FBiH government will prepare an analysis of the impact on pension benefits and a schedule of budget transfers to the pension fund in consultation with the World Bank and the IMF staff. To help ensure greater discipline in the payment of pension contributions the entity governments will develop with assistance from the World Bank, comprehensive strategies to tackle remaining loss-making state-owned enterprises and public companies by either restructuring or liquidating these companies (see above). The new bankruptcy laws will also help in this regard.

- We will strive to improve the targeting of social assistance to protect the most vulnerable in an effective manner. To this end, the FBiH parliament will adopt the Law on Single Registry of Beneficiaries of Benefits without Contribution in end-September 2016, which allows for a centralized database of beneficiaries of social transfers to become operational by end-November 2016. Based on the data in the centralized database of beneficiaries we will prepare a report and plan to improve the targeting of social transfers by December 2016 (structural benchmark). In addition, to prevent abuse in the war veteran benefit system, audits of beneficiaries of privileged pensions in the FBiH will be expedited. The first stage of the audit process, to verify the eligibility of the existing beneficiaries for all categories of war veterans’ benefits including privileged pensions, will be completed by end-December 2016, and all stages of the audit process will be completed by end-June 2017 (a structural benchmark). We will refrain from amending the legislation that regulates war related benefits without consultation with the World Bank and IMF staff.

17. Strengthening controls over lower levels of government, extra-budgetary funds, and state-owned enterprises is of utmost importance to fully account for and to stop the increase in uncovered liabilities. In particular:

- Following the adoption of the new FBiH Law on Budgets, the implementing regulations and rulebooks have been finalized and adopted, including the Law on Treasury and Accounting Policies. The FBiH Fiscal Coordination Body was established and has met regularly. Going forward, this coordination body is expected to meet at least semi-annually. In order to strengthen fiscal prudence at lower levels of government, we amended the FBiH Law on Budgets with the following provisions: (i) lower levels of government will be bound to use in their budgets the revenue projections prepared by the FBiH Ministry of Finance for both indirect and direct taxes; and (ii) cantons that end their fiscal year with outstanding liabilities will be required to include in their budgets a detailed plan to clear these liabilities within a five year period. The FBiH government will also aim to strengthen controls over lower level governments’ borrowing, including by amendments to the Law on Debt, Borrowing, and Guarantees by end-December, 2016 (structural benchmark) and by adopting the Law on Public Revenue Allocation by end-March 2017. The entity governments, with assistance from the World Bank, are working to document the stock of arrears in lower levels of government, including establishing a reporting
system for capturing health sector arrears in both entities and unpaid liabilities/arrears at lower levels of government in the FBiH.

- A new Fiscal Responsibility Law was adopted by the RS parliament, with a view to ensuring long-term fiscal sustainability and enhancing transparency. The new law, in addition to establishing clear fiscal rules and an independent Fiscal Council, will enhance the oversight over spending units in the RS that operate outside of the treasury general ledger and have their own transaction accounts (including special funds). These units will be required to obtain Ministry of Finance approval of their financial plans before they submit these to the RS government for approval, while they will also be required to refrain from incurring liabilities in excess of the funds available to them.

- In consultation with USAID, we will aim to finalize the expansion of the treasury systems to lower levels of government, including health centers in the RS and budget management systems in cantons in the FBiH, by [end-March 2017] (structural benchmarks).

- The FBiH government will introduce a program of providing loan or grant financing to cantons that agree to adopt plans to restrain wages and reduce overall employment that is fully consistent with the FBiH plan by [end-December 2016].

**Safeguarding financial stability and supporting credit growth**

18. The CBA is a cornerstone of our economic policies, as it provides stability in an otherwise uncertain and complex environment. We reaffirm our commitment to maintaining the CBA as constituted by law (a continuous structural benchmark) and to safeguard the independence of the Central Bank of Bosnia and Herzegovina (CBBH). As such, we will continue to refrain from any actions that would weaken the CBA and the CBBH as the institution entrusted with its operation; in particular we will refrain from using foreign reserves at the CBBH for any budgetary or public investment purposes, and therefore zero ceiling on transfers and credits from the CBBH to the public sector as a continuous performance criterion was set.

19. Our financial sector weathered relatively well the global financial crisis and the subsequent years of weak economic growth, as well as the floods in 2014. While the banking system is liquid and adequately capitalized at the aggregate level, vulnerabilities remain to be tackled. Non-performing loans (NPLs) to total loan ratios remain elevated, and the growth in loans to the private sector is quite low, and some banks need to improve their capital positions and to undergo deeper restructuring of their balance sheets to restore long-term viability. Against this backdrop, we are continuing to closely monitor developments in the financial sector to safeguard financial stability. We will not take any measure that undermines financial stability, including imposing mandatory conversion of any foreign currency-denominated loans into local currency (a continuous structural benchmark). We understand the crucial importance of this commitment to the success of the EFF.

20. The banking agencies continue to address weaknesses in the banking sector. The banking agencies received the complete reports of the detailed asset quality reviews (AQRs) conducted for banks that were under enhanced supervision in 2013. The banking agencies instructed these banks to take remedial measures to address shortcomings identified in the AQRs, including by submitting recapitalization plans to the agencies. Two small banks that failed to raise new capital were closed and
insured deposits were paid out promptly. Banks that have been under enhanced supervision in 2015 or that experienced a rapid credit expansion relative to the market in 2012-14 (i.e. with an average annual credit growth rate greater than 10 percent over that period) and that had not already conducted AQRs have hired reputable external auditors to conduct detailed AQRs under the terms of reference provided by the banking agencies in line with the IMF staff recommendations (prior action). These reviews are expected to be completed by end-June 2016 for the banks from the FBiH and end-September 2016 for the banks from the RS. Based on these reviews, the banking agencies will develop comprehensive entity strategies to address the vulnerabilities in the banking system, by requesting the owners of banks to make up any shortfall against the regulatory capital requirements through cash injection and restructure the banks as needed. The banks will submit plans to address the capital shortfall and restore the overall soundness, which will be approved by the banking agencies by end-August 2016 for banks in the FBiH (a structural benchmark) and end-November 2016 for the banks from the RS (a structural benchmark). The banking agencies will monitor the implementation of the plans and take prompt actions to address identified vulnerabilities. We will ensure that proper backup public backstops are in place for any systemic cases. For the remaining banks, AQRs will be conducted in 2017.

21. We are also pressing forward with our legislative agenda aimed at: (i) modernizing our banking sector laws and regulations; (ii) strengthen the cooperation and coordination and information exchange among the financial sector regulators; (iii) addressing the high level of NPLs; and (iv) improving the framework for liquidity management. This includes:

- Completing the new laws on banks in both entities in line with EU directives and Basel requirements. The working groups tasked with drafting banking legislation have made significant progress, with the assistance of the IMF staff and the World Bank, and first drafts of the new banking laws are completed. These new laws will strengthen supervisors’ corrective and enforcement powers, introduce consolidated supervision of banking groups, and introduce a comprehensive bank resolution framework. Additionally, special reserve requirement for public deposits will be repealed in the new laws to avoid the risk of distorting banks’ funding structure, meanwhile we will safeguard public resources through other reform measures (see below). We will also review and amend as necessary related legislations, such as the Deposit Insurance Agency (DIA) Law, with the assistance of the World Bank, and Banking Agency Laws, in order to ensure a consistent and comprehensive bank resolution framework. In addition to their supervisory roles, the banking agencies will be designated as the bank resolution authorities in their respective jurisdictions, while having an appropriate degree of separation between the supervision and resolution functions to avoid potential conflicts of interest. The DIA Law will also be amended to allow the use of the DIF for financing bank resolutions, subject to clear safeguards to the DIA’s main objective of protecting insured depositors. The new banking laws will not contain any provisions or references to any other financing arrangement for bank resolution, which will be deferred to a later stage when we will consult with IMF staff on the appropriate institutional construct. The harmonized final drafts of these legislations will be shared with the IMF staff for review by end-July 2016. We then expect the respective entity parliaments to adopt the draft Laws on Banks and needed amendments to Banking Agency Laws and the BiH parliament to adopt amendments to DIA Law by end-November 2016 (structural benchmarks).
• We will strengthen the cooperation and information exchange among the banking agencies, the DIA, and the CBBH to monitor and mitigate systemic risk effectively. The new Banking Laws will include harmonized definitions of systemically important banks (SIBs) which will be determined according to a commonly agreed methodology by the banking agencies, the DIA, and the CBBH. The methodology will be published on the websites of all four authorities. The list of the SIBs will be updated annually. In consultation with the IMF staff and the World Bank, the banking agencies, the DIA, and the CBBH will sign a comprehensive Financial Stability Memorandum of Understanding (MoU) building on and replacing the MoU on “Coordination on Banking Supervision and Cooperation and Exchange of Information” and the MoU between the banking agencies and the DIA by end-December 2016. The Financial Stability MoU will provide, among others, for a regular exchange of information on the SIBs, including quarterly offsite information, and for joint inspections of the SIBs. The Banking Coordination Group will review this information in quarterly meetings and propose measures to the Standing Committee for Financial Stability (SCFS) every six months in order to address any systemic risks. The SCFS will recommend appropriate mitigating measures, to be taken and implemented by the relevant authorities based on their competencies. The Financial Stability Report will include a section endorsed by the Banking Coordination Group on relevant conclusions and policies implemented to address systemic risks in the reference period.

• To further facilitate coordination among the financial sector authorities, the BiH parliament will amend the DIA law to provide for the inclusion of the heads of the banking agencies or their deputies in Governing Board meetings as non-voting participants. Furthermore, the entity Banking Agency Laws will be amended so that the chairs of the respective banking agency governing boards are obliged to invite the heads of the other entity banking agency and of the DIA or their deputies to participate in all governing board’s meetings as non-voting participants. These provisions will be reflected in the new legislative package to be adopted by end-November 2016 (structural benchmarks).

• The entity banking agencies will also work with a Resident Advisor from the IMF to identify and address remaining shortcomings in the bank supervisory framework.

• We will improve the framework for recovering and resolving NPLs as part of the new Banking Laws. This will include, inter alia: (i) provisions to support the purchase and sale of NPLs by end-November 2016; (ii) a clarification by the ITA that NPL sales by banks are not subject to VAT, issued by end-November 2016; and (iii) to analyze possibilities of adopting guidelines for out-of-court restructuring. We will continue our consultation and cooperation with the IMF staff and the World Bank in these areas.

• To strengthen the liquidity management framework, we will consider introducing liquidity coverage ratios (LCRs) in our liquidity regulations to improve banks’ liquidity risk management. We will seek technical assistance from the IMF staff to help the banking agencies with the design and calibration of the LCRs for the financial system. Given the high level of liquidity in the system, the CBBH has raised reserve requirements (RRs) for banks to rebuild liquidity buffers. The CBBH will tailor the use of reserve requirements more toward prudential purposes by increasing the number of holding periods during which the bank under stress can breach the reserve
requirements and supplementing this with minimum holding thresholds and higher penalty rates for a breach before more severe sanctions are applied.

22. We are also advancing other legislation and regulations that will improve the functioning and transparency of our financial system, including by further improving our framework for combating money laundering and financing of terrorism. Following the adoption of a new BiH AML/CFT law and the necessary amendments to the BiH Criminal Code in line with recommendations by MONEYVAL, we will timely adopt additional regulatory and legislative changes that are needed to align our framework with the recommendations of the Financial Action Task Force.

23. To help maintain financial market stability, minimize fiscal costs, and mitigate litigation risks associated with dealing with weak banks, the entity governments are taking further measures to improve operations of the entity development banks and to introduce oversight by the banking agencies. We seek assistance from the IMF staff and the World Bank to improve risk management and transparency of the entity development bank operation. Amendments to the laws on entity development banks and amendments to the Banking Agency Laws will be introduced, in line with the IMF staff and World Bank recommendations, by end-November 2016 (structural benchmarks) to:

- Clarify the mandate of developmental objectives related to addressing market failures and limit the permissible activities, including by removing direct lending channels to the private sector;
- Improve the governance of the development banks to operate at arm’s length from the government and require a contract for the management board that ties management compensation to actual performance;
- The entity governments will subject the development banks to appropriate supervision and regulation by the entity banking agencies;
- Require publication of annual external audit of the development banks and all funds under management by reputable international accounting firms on the development banks' websites.

24. The entity governments and the respective development bank supervisory boards will sign, within the next 12 months, a relationship framework that would clarify the roles and responsibilities of the parties to ensure that development banks have viable business models and are run on commercial basis. We will undertake this work in line with advice from IMF and World Bank staff.

25. We will strengthen our public procurement standards of placing public deposits, with the assistance from the IMF staff. We will prepare the analysis of necessary legislative measures for safeguarding public resources in line with IMF staff recommendations by end December 2016, while the amendments of relevant legislations and standards will be adopted by the respective BiH and entity parliaments in 2017.

26. In their continued efforts of cooperation with foreign supervisory bodies, the banking agencies have signed MoUs with the European Banking Authority and the Austrian Financial Market Authority that would allow for closer cooperation and exchange of information. The banking agencies are working on signing MoUs with other relevant supervisory bodies.
27. In order to improve the oversight of the payment system, the CBBH will broaden the scope of its accounts registry to include additional information, including main transaction accounts and accounts of individuals.

**Program modalities**

28. We believe that the policies set forth in this Letter of Intent are adequate to achieve the objectives of our economic program. We stand ready, however, to take any additional measures that may be needed to achieve the objectives of our economic program. We will consult with the IMF on the adoption of additional policy measures and in advance of any revision to the policies contained in our economic program, in accordance with IMF policies on such consultation. We will continue to provide IMF staff with the necessary information for assessing progress in implementing our program and will maintain a close policy dialogue with IMF staff. We will provide any necessary information to facilitate the Safeguards Assessment of the CBBH. We will also refrain from introducing or intensifying any exchange and trade restrictions and other measures or policies that could worsen balance of payments difficulties.

29. The program will be monitored through quarterly and continuous quantitative performance criteria, indicative targets, prior actions, and structural benchmarks. Quantitative performance criteria for 2016 and first half of 2017, continuous performance criteria, and indicative targets for 2016 and first half of 2017 are set out in Table 1; and prior actions and structural benchmarks are set out in Table 2. The understandings between the authorities of BiH and IMF staff regarding the quantitative performance criteria and indicative targets are further described in the attached Technical Memorandum of Understanding (TMU). Under the Arrangement IMF resources will be disbursed to the CBBH, and the domestic currency equivalent will be credited to a deposit account of BiH for transactions with IMF, to FBiH and RS subaccounts, earmarked for the budgets of the FBiH and the RS in 2/3 : 1/3 split respectively, as specified in the Memorandum of Understanding. The MoU between the entity governments and the CBBH has been signed in June 2016. We request approval of the new extended arrangement under the EFF by the IMF Executive Board and request that the Executive Board also approves to make available SDR 443.042 million (262 percent of quota) upon approval of the arrangement. The first review of the program is expected to take place on or after December 25, 2016.

30. The CBBH continues to maintain a strong safeguards framework and internal control environment and no significant changes have occurred since the last assessment. As required by the IMF safeguards policy, we will continue to engage independent external audit firms to conduct the audit of the CBBH in accordance with International Standards on Auditing.

31. We authorize the IMF to publish this Letter of Intent and its attachments, as well as the related staff report on the IMF’s website following consideration of our requests by the IMF’s Executive Board.
Denis Zvездич
Chairman
of the Council of Ministers
Bosnia and Herzegovina

Fadil Novalić
Prime Minister
Federation of Bosnia and Herzegovina

Željka Cvijanović
Prime Minister
Republika Srpska

Vjekoslav Bevanda
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