

DOI: 10.7251/GFP2313035D

UDC: 336.717.061:336.741.2(497.6RS)

**Pregledni naučni rad**

*Datum prijema rada:*  
25. jun 2023.

*Datum prihvatanja rada:*  
29. jun 2023.

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## Significance and Role of Control Bodies in the Banking System of the Republic of Srpska

**Abstract:** The establishment of open financial markets and the provision of financial services outside national borders determined the establishment of international standards in certain segments of banking operations and the obligation to adapt national banking regulations to the requirements of removing administrative restrictions on the freedom of movement of capital and establishing mechanisms that will ensure the safety and stability of the banking system. The aforementioned requirements determined the regulation of the banking system in market-oriented countries and countries that were undergoing or are still in the process of transition. In order to preserve the stability of the banking system, prudential control is particularly important, as one of the basic elements of security regulation, which aims to ensure the stability and security of the banking system, reduce the possibility of risk in the operations of financial organizations that make up the structure of the banking system, and provide appropriate protection to investors and users of banking services. In this sense, a special accent in the regulation of modern banking systems was emphasized in the establishment of a supervisor for the banking system, who directs and improves the work of banks, controls the legality of work and maintains the prescribed standards in work, the establishment of institutional control, which is realized in a combination of the system of internal control and internal audit and, extra-institutional control, which is recognized as external audit. The aim of this work is to investigate the importance and role of control bodies in the banking system of the Republic of Srpska, which operate according to the methodology of the supervision of the banking system, which is entrusted to the Banking Agency of the Republic of Srpska, the control bodies of the bank and the non-institutional control of the financial operations of financial organizations in the structure of the banking system, which is performed by an external auditor.

**Keywords:** banking system, security regulation, public control, institutional control.

### 1. INTRODUCTION

The role of the banking system within the overall economic organization and development of a country and the very activity of banks determined that this area should be specially

regulated and that the banking system should be treated as an area of special importance. The regulation of the banking system implies clear legal regulations that regulate the establishment and operation of banks and other financial organizations that make up the structure of the banking system. The regulation of the banking system itself is a dynamic process because it depends on socio-economic organization, ownership relations, technological development, adaptation to the needs of clients, openness of the state to foreign markets, membership of certain international organizations, that is, on changes that occur on the internal and international level.<sup>1</sup>

The establishment of open financial markets and the provision of financial services outside national borders imposed certain requirements in the direction of establishing international principles and standards that will represent the framework for the regulation of modern banking systems, based on the regulation of security. The main goal of security regulation is to find a model in order to act preventively on identifying and eliminating risks in bank operations and to ensure the protection of the interests of all participants within the banking system.<sup>2</sup>

A special accent in the regulation of modern banking systems was emphasized when establishing the concept of prudential control, which represents the three-layered control of the operations of banks and other financial organizations in the structure of the banking system. Of particular importance in this concept of control is permanent supervision, i.e. public control of banking system, entrusted to the supervisor for the banking system, who directs and improves the work of banks and other financial organizations that make up the structure of the banking system, controls the legality of their work and maintains the prescribed standards in work, and institutional control, which is established within the bank, recognized as internal control and internal audit and external audit of financial operations, performed by a professional who is not employed by the bank, i.e. an external auditor.

In determining the concept of prudential control, a special role is played by the Basel Committee for the Supervision of Banks,<sup>3</sup> which determined the standards for preventive supervision over the operations of banks and the stability of the banking system. These international standards determined the basis of the regulation of the banking system, with a special emphasis on the establishment of a supervisor, that is, a public controller of the banking sector. Supervision includes the authority of the supervisor to issue a license for the operation of a bank or other credit institution, which includes the establishment of strict conditions for the establishment of a bank and the supervisor's critical assessment of whether the bank will comply with the rules of market competition and whether it will survive on the market, up to the authority of the supervisor to have permanent supervision of the work of banks and other credit institutions with a clearly defined scope of authority to take corrective measures and authority to withdraw approval for the work of a bank or

<sup>1</sup> Drljača, Z., Maričić, G. (2015). Osnovni elementi regulacije bankarskog sistema Republike Srpske sa osvrtom na ulogu Agencije za bankarstvo Republike Srpske. In: *Prilagodavanje pravne regulative aktuelnim trendovima u regionu*. Novi Sad: Pravni fakultet za privredu i pravosuđe Univerziteta Privredna akademija u Novom Sadu, 45-58.

<sup>2</sup> Drljača, Z., Džaklula, M. (2022). *Bankarsko pravo i hartije od vrijednosti*. Banja Luka: Panevropski univerzitet Apeiron, 27-39.

<sup>3</sup> Available at: [https://www.google.com/search?q=The+Basel+Committee+on+Banking+Supervision+\(BCBS\)\(1.6.2023\)](https://www.google.com/search?q=The+Basel+Committee+on+Banking+Supervision+(BCBS)(1.6.2023)).

other credit institution. In order to support market discipline, the importance of supervisor reporting on the state of the banking system is emphasized. In addition to the aforementioned standards, determining the regulation of the banking system was also dealt by certain directives of the European Union, which refer to the harmonization of economic, legal and administrative regulations for the removal of administrative barriers for the free flow of capital and the free establishment of banks outside national borders and the performance of banking operations outside national borders, regardless of the citizenship of the founder.<sup>4</sup>

In the Republic of Srpska, the reform of the banking system was carried out, and the structure and control system of the banking system was established, based on the guidelines and standards of the Basel Committee and certain directives of the European Union.

## **2. BASIC ELEMENTS OF THE REGULATION OF THE BANKING SYSTEM OF THE REPUBLIC OF SRPSKA**

The banking system in Bosnia and Herzegovina (hereinafter referred to as B&H) reflects the constitutional arrangement and organization of B&H, which is determined in Article 1, point 3 of the Constitution of Bosnia and Herzegovina,<sup>5</sup> in such a way that B&H consists of two entities: the Federation of B&H and the Republic of Srpska. When determining the division of competences between the institutions of B&H and entity bodies, the Constitution of B&H, according to the model of positive,<sup>6</sup> in Article 3, point 1, determined the areas and competences of the institutions of B&H, so among other things, that the competence of the institutions of B&H is monetary policy, while Article 7 of the Constitution of Bosnia and Herzegovina stipulates that the Central Bank of Bosnia and Herzegovina is the sole authority for issuing money and monetary policy in Bosnia and Herzegovina. The Central Bank of Bosnia and Herzegovina was established in 1997, by the Law on the Central Bank of Bosnia and Herzegovina,<sup>7</sup> while the monetary system of Bosnia and Herzegovina was established in August 1998, when this bank started operating.

The functions and powers of the entities in Article 3 point 3 a) of the Constitution of B&H are determined by the general clause of general jurisdiction, in such a way that all state functions and powers not expressly assigned to the institutions of B&H by the Constitution of B&H belong to the entities, from which it follows that in B&H monetary policy

<sup>4</sup> Škrbić, S. (2022). *Usporedno-pravni aspekti regulatornog okvira bankarskog sistema Republike Srpske u odnosu na regulatorni okvir zemalja u regionalnom okruženju* (doktorska disertacija). Banja Luka: Fakultet pravnih nauka Panevropski univerzitet Apeiron, 48-49.

<sup>5</sup> The General Framework Agreement for Peace (Dayton Agreement) was agreed on November 21, 1995 at the Wright Patterson Air Force Base in the town of Dayton (USA), and was signed on December 14, 1995 in Paris. The agreement itself consists of 11 annexes, and Annex 4 represents the Constitution of Bosnia and Herzegovina. From a formal legal point of view, it should be noted that this agreement has not yet been officially translated from English into the official languages of BiH, nor has it been published in the Official Gazette of BiH, the Official Gazette of the Republic of Srpska and the Official Gazette of the Federation of BiH.

<sup>6</sup> Kuzmanović, R.(2002). *Ustavno pravo-Treće izmijenjeno i dopunjeno izdanje*. Banja Luka: Pravni fakultet Univerziteta u Banjoj Luci, 313

<sup>7</sup> Law on the Central Bank of Bosnia and Herzegovina, *Official Gazette of B&H*, No. 1/97, 29/02, 8/03, 13/03, 14/03, 76/06 and 32/07.

is under the jurisdiction of B&H institutions, while the regulation of the banking system belongs to the entities. Thus, in the Constitution of the Republic of Srpska,<sup>8</sup> in Article 68, item 7, it is determined that the Republic of Srpska regulates and provides the banking system, while in the Constitution of the Federation of B&H,<sup>9</sup> in Chapter III item 1. exclusive list of jurisdictions of the Federation of Bosnia and Herzegovina is prescribed, and among other things, it is prescribed that the Federation of Bosnia and Herzegovina is competent in the area of this entity to regulate finances and financial institutions in the Federation of Bosnia and Herzegovina, which includes the banking system. Based on the analysis of the aforementioned constitutional provisions, we can conclude that there is no single banking system in B&H, but that the regulation of the banking system is the original constitutional competence of the entities.

In the period from 1992 until the establishment of the monetary system of B&H, on the basis of the original constitutional powers, the Republic of Srpska regulated and secured the monetary and banking system of the Republic of Srpska (the competence to regulate the monetary system was deleted by Amendment XXXII of the Constitution of the Republic of Srpska). In the institutional sense, the monetary policy in the territory of the Republic of Srpska was carried out by the National Bank of the Republic of Srpska, which ceased to operate with the establishment of the Banking Agency of the Republic of Srpska.<sup>10</sup>

In addition to the establishment of a monetary system at the central level of government in B&H, the key factors that determined the reform of the banking system of both the Republic of Srpska and the Federation of B&H were the obligations related to the transition process and the obligations that B&H undertook by launching the initiative to join the European Union.<sup>11</sup> The very decision of B&H to become a member of the European Union created obligations to carry out reforms in the priority areas from the Report on the Feasibility Study for B&H, so among other obligations, the implementation and reform of the banking system, which meant that banking regulations should be harmonized with certain legal and economic criteria, which are determined by the rules of the European Union.<sup>12</sup> Within the framework of meeting the economic conditions according to the rules of the European Union, the criteria refer to the existence of a market economy and the ability of economic entities to withstand competition in the internal market of this international organization, which is based on four key freedoms: the free flow of people, goods, capital and the freedom to provide services in conditions of competition. In order to create assumptions for the free flow and security of capital, it was necessary to harmonize the bank-

<sup>8</sup> Constitution of the Republic of Srpska, *Official Gazette of the Republic of Srpska*, No. 2/12-refined text, 28/94, 8/96, 13/96, 15/96, 16/96, 21/96, 21/02, 26/02, 30/02, 31/02, 69/02, 31/03, 98/03, 115/05, 117/05, 48/11.

<sup>9</sup> Constitution of the B&H Federation, *Official Gazette of B&H Federation*, No. br. 1/94 and 13/97.

<sup>10</sup> The Law on Banking Agency of the Republic of Srpska, *Official Gazette of the Republic of Srpska*, No.10/98, 16/00, 18/01, 71/02, 18/03, 39/03, 123/06 and 40/11. New Law on Banking Agency of the Republic of Srpska, *Official Gazette of the Republic of Srpska*, No. 59/13, 4/17 and 9/18 .

<sup>11</sup> Decision on launching the initiative for accession to the European Union, *Official Gazette of BiH*, No.12/98.

<sup>12</sup> Misita, N. (2012). *Osnovi prava Evropske unije*. Sarajevo: Magistrat, 79.

ing regulations of the Republic of Srpska with certain directives of the European Union. The most significant is the first banking directive, EU 77/780/EEC,<sup>13</sup> which determined the basic conditions for carrying out banking activities within the countries of the European Union, and defined the concept of a bank as a credit institution and the distinction between commercial banks and other financial organizations, determining that a bank is a credit institution – a company whose operations include taking deposits or other repayable assets from the public and granting loans for its own account.

In addition to the first banking directive, the directives on the liberalization of the free movement of capital and the harmonization of legal and administrative acts related to capital transactions are also significant; transaction with securities and joint investments; directives on bookkeeping, final accounts and consolidated balance sheets of banks and other financial institutions; directives that determine the solvency ratio of banks and other financial institutions, capital adequacy for investment and credit institutions, and some other directives. Harmonization also referred to Directive 91/308/EEC on preventing the use of financial systems for the purpose of money laundering,<sup>14</sup> and Directive 2000/12/EC,<sup>15</sup> which codified European Union banking law.

In the process of reforming the banking system in Bosnia and Herzegovina, it was necessary to incorporate certain international standards defined by the Basel Committee into the banking regulation. In essence, the basic elements of the banking system reform of the Republic of Srpska were: privatization of state capital in banks, determination of the structure of the banking system in accordance with Article 1 of the First Banking Directive and standards of the Basel Committee,<sup>16</sup> establishment of public control of the banking system based on the supervision model by establishing the Banking Agency of the Republic of Srpska, determination of standards for the performance of banks and other financial organizations that make up the structure of the banking system. From the above, it follows that the regulation of the banking system of the Republic of Srpska cannot be viewed in isolation from the global trends of the international banking market, international principles and standards in this area, and the requirements of the European Union in the process of European integration. For the sake of comparison, it should be emphasized that the reforms of the banking system took place in the same way in both entities in B&H, and that the regulations regulating the banking system in the Federation of B&H are harmonized with international standards of bank operations and directives of the European Union.<sup>17</sup>

The basic characteristics of the regulation of the banking system of the Republic of Srpska are determined by: the Law on the Banking Agency of the Republic of Srpska, the

<sup>13</sup> Council Directive 77/780/EEC of 12 December 1977 on the coordination of the laws, regulations and administrative provisions relating to the taking up and pursuit of the business of credit institutions, *Official Journal of the European Communities (OJ)*, L322, 17/12/1977.

<sup>14</sup> Council Directive 91/308/EEC of 10 June 1991 on prevention of the use of the financial system for the purpose of money laundering, *OJ*, L 166, 28 June 1991.

<sup>15</sup> Directive 2000/12/EC of the European Parliament and of the Council of 20 March 2000 relating to the taking up and pursuit of the business of credit institutions, *OJ*, L126, 26/05/2000.

<sup>16</sup> Drljača, Z. (2015). Regulacija i kontrola bankarskog sistema Republike Srpske. *Godišnjak fakulteta pravnih nauka Panevropskog univerziteta Apeiron*. Banja Luka, 262-273.

<sup>17</sup> Law on the Banking Agency of the Federation of Bosnia and Herzegovina, *Official Gazette of the Federation of Bosnia and Herzegovina*, No.70/17.

Law on Banks of the Republic of Srpska, the Law on Microcredit Organizations, the Law on Savings and Loan Organizations and the Law on Leasing.<sup>18</sup>

The legal solutions that regulate banks, microcredit organizations, savings and credit organizations and leasing companies are designed on the basis of the security regulation system, and the most important elements are: the determination of the minimum founding capital, the emphasis on stricter work control, which creates preconditions for the regulation and stability of the banking system, the protection of fair competition in the banking sector, the application of modern information technologies, a high degree of professional work and a high degree of responsibility. Other important elements of the regulation of the banking system are the organization of business in banks based on the principles of corporate management, the determination that personal and professional data about bank clients must have special protection treatment, transparency of business and an effective control system, which will be discussed in more detail later in the text.

When managing risks and determining methods for risk assessment, the legal regulation does not cumulate the competence of one body of the bank, but entrusts it to the bank's credit committee, the internal control department and the audit committee, and the responsibility of the bank's assembly and the supervisory board for quantitative and qualitative assurance and capital maintenance. The laws governing the establishment and activity of banks, microcredit organizations, savings and credit organizations and leasing companies regulate the two-phase establishment procedure, i.e. the preliminary procedure for issuing a work permit conducted by the Banking Agency of the Republic of Srpska and the procedure at the competent court for business registration subjects. All founders of the bank are treated equally; no distinction is made between domestic and foreign legal entities, which mean that there are no administrative barriers for the free flow of capital in the Republic of Srpska.

However, although the reform of the banking system has been carried out since 1999, it should be borne in mind that with the signing of the Stabilization and Association Agreement between the European Communities and their member states and Bosnia and Herzegovina,<sup>19</sup> The obligation to harmonize banking regulations with competition rules and foreign capital investment rules was assumed, which is a constant process and obligation of the entity, depending on the dynamics of determining the legal instruments of the European Union in this area. The provision of Article 6 of the Law on Banks of the Republic of Srpska also refers to this obligation,<sup>20</sup> which strictly prescribes the prohibition of violation of the principle of competition, in such a way that the bank is prohibited from expressly or tacitly concluding agreements, making decisions and other acts and entering into transactions that have the objective to significantly prevent, limit or distort market competition, as well as the prohibition to abuse a dominant position or to implement a concentration that significantly prevents, limits or distorts competition by creating or strengthening a dominant position on the financial market, in such a way that the mainte-

<sup>18</sup> Laws available at: <https://www.abrs.ba> (1.6.2023).

<sup>19</sup> Stabilization and Association Agreement between the European Communities and their member states and Bosnia and Herzegovina, *Official Gazette of Bosnia and Herzegovina - International Agreements*, No.10/08.

<sup>20</sup> Law on Banks of the Republic of Srpska, *Official Gazette of the Republic of Srpska*, No.4/17, 19/18 and 54/19.

nance of the principle of competition in banks, also applies provisions of the law governing the protection of market competition.<sup>21</sup>

### 3. CONTROL SYSTEM OF MODERN BANKING SYSTEMS

The control of modern banking systems is based on the concept of prudential control, a term from the English adjective *prudential*, which means prudent, thoughtful, which is used as a scientific and professional term in domestic literature after the adoption of international standards of banking regulation.<sup>22</sup> This concept represents the three-layer control, which means that the control of the banking system is not concentrated only in the competence of the supervisor - the public control body, but with a precisely defined scope of authorities also entrusted to the bank's bodies in charge of internal control and internal audit, and the third pillar of control of financial operations, i.e. non-institutional control, performed by an external auditor.

In order to preserve the stability of the banking system, the supervisor's role is of an utmost relevance for the system which performs the public control of the overall banking system, i.e. the control of the work legality, law application, design and maintenance of statutory standards, rule and instruments, which enable risk detection in the governance of banks and other credit organizations, which may further affect the stability of not only one bank's business but of the entire financial system. In addition to regular controls, the supervisor plays a pertinent part in preventive controls in terms of issuing working licenses for banks and other financial organizations within the banking system and authorized bodies by setting minimum standards for activities of all financial organizations of the banking system, estimating different report content standard, control standards, and risk mitigation standards referring to credits, market, operations, risk liquidity, risk concentration, interest rate risk, strategic risk, settlement risk, reputational risk, and business compliance risk, especially the risk of defining corrective and other measures set forth by the supervisor.

Given this three-layered control system, a prerequisite for a comprehensive supervision is the system of institutional control within a bank through establishing internal controls referring both to administrative and accounting internal controls, and internal revisions focusing on objectivity and accuracy of financial reports and identification of risk management shortcomings which might hold a negative impact on a bank's business. The external revision, as a third pillar of control, must provide the accuracy of a bank's financial report design by an authorized licensed external supervisor who is not an employee of a bank or some other credit organization.<sup>23</sup>

### 4. CONTROL BODIES OF THE REPUBLIC OF SRPSKA'S BANKING SYSTEM

The establishment of a three-layered control system as a part of the banking system reforms in the Republic of Srpska is one of key elements, which we may infer based on the study of the regulatory framework of the banking system and the analysis of the Law on the Banking Agency of the Republic of Srpska, Article 2, point a) stating that "*the banking*

<sup>21</sup> Drljača, Džakula, 87.

<sup>22</sup> Vasiljević, M., Vasiljević, B., Malinić, D. (2008). *Finansijska tržišta*. Beograd: Komisija za hartije od vrijednosti, 23.

<sup>23</sup> Drljača, Džakula, 112.

*system of the Republic of Srpska encompasses banks, microcredit organizations, savings organizations, and other financial institutions the activities and foundation of which is regulated by special laws through which the Banking Agency is authorized to issue licenses and work approvals and supervise business activities in this regard.*" Hence, in setting forth the structure of the banking systems, the lawmaker determines the Agency's role, in line with the Basel Accords I, as a supervisor because the structure of the banking system covers only financial organizations licensed by the Agency.

Given special laws which define conditions for the foundation of financial organizations, Article 1 of First banking directive of the European Union and Article 2 point a) of the Law on Banking Agency of the Republic of Srpska, which defines that the structure of the banking system covers only financial organizations licenced by the Banking Agency, we should point out that the structure of the banking system of the Republic of Srpska also covers leasing companies in line with the Article 10, paragraph 1) of the Law on Leasing,<sup>24</sup> stating that leasing activities can only be performed by entities organized as capital companies headquartered in the Republic of Srpska licensed for leasing activities by the Banking Agency of the Republic of Srpska.

Apart from defining the banking system structure, Article 3 of the Law on Banking Agency of the Republic of Srpska states that the primary goal of the Agency for preservation and strengthening of the banking system is to preserve and strengthen the stability of the banking system, improve the safe, quality and legality of activities, and Article 4 which determines the jurisdiction of the Agency defines that the Agency is funded for the purpose of arranging and controlling the banking system and that it is autonomous and independent.

Essentially, the Law on the Banking Agency of the Republic of Srpska determines the structure of the Republic of Srpska's banking system, the role of the Agency in the preservation, improvement and stability of the banking system, and the control role of the Agency, whereas special laws for each financial organization define foundation requirements, activities approved by the Agency, and other pertinent elements of activities, organization, management and institutional control (internal control and internal revision). Apart from the obligatory internal controls, there is also the mandatory external revision authorized to provide opinion on financial activities. By analyzing the aforementioned legal provisions, we may infer that the control system of the Republic of Srpska's banking system follows other modern banking systems and is organized according to the principles of the three-level prudential control which is realized by the following: the control role of the Agency, which, besides the supervision-like control of the business of financial organization within the banking system, also performs preventive controls in order to preserve and strengthen the stability of the banking system and improve safety, quality and legality; institutional control within a financial organization via internal controls and internal revisions as well as non-institutional control or external revision performed by authorized external supervisor.

#### **4.1. The control role of the Banking Agency of the Republic of Srpska**

Following international standards in the determination of role and authorities of the Agency, the lawmaker defines that the Agency is autonomous and independent, which is also, included in the first section of the Basel Accords I, as a prerequisite for an efficient

<sup>24</sup> Leasing Law, *Official Gazette of the Republic of Srpska*, No. 70/07 and 116/11.

bank supervision.<sup>25</sup> The Agency's autonomy and independence may be regarded from the aspects of institutional, personal and financial independence and autonomy.

*Institutional autonomy* is determined by the fact that the Agency is founded by the lawmaker, with very specific and clear authorities and jurisdictions. The supervisors get the highest level of institutional independence as they are elected by the Parliament as the carrier of sovereignty, in which process the sovereignty is partly passed on from the Parliament to the supervisor or the body authorized for the public control of the banking system.<sup>26</sup>

*Personal autonomy* is determined while nominating members of the Agency's Steering Board, manager, and deputy manager, who are, based on the public competition procedure, elected for the five year period by the Republic of Srpska's National Assembly at the proposal of the Government. Members of the Steering Board are responsible before the Republic of Srpska's Assembly, and the manager and vice-manager are responsible before the Steering Board and the Republic of Srpska's Assembly; the Agency's activities are supervised by the National Assembly. The National Assembly of the Republic of Srpska supervises the Agency by reviewing and adopting (or dismissing) the report on the condition of the banking system of the Republic of Srpska and the report on Agency's activities and results submitted by the Agency to the Republic of Srpska's National Assembly at latest on June 30 for the previous calendar year.

*Financial autonomy* is essentially the peak of autonomy and independence of banking supervisors because it confirms that the Agency is not bound to the budget, which is also one of the Basel Accords I standards. The financial autonomy of the Agency is obtained as all its funds are collected from fees for licensing banks and other financial organizations, monthly fees that banks and other financial organizations within the banking system pay for the supervision of their activities, and fees for other services provided within the Agency's jurisdiction.

The amount of fees funding the Agency is determined by the special decision made by the Steering Board of the Agency approved by the Republic of Spska's Government.

Defining the goal of its foundation, the independent and autonomous Agency acts as a supervisor of the banking system in line with the standards of the Basel Accords I, i.e. preservation, strengthening and improvement of the banking system, continuous preventive controls through licensing banks and other credit organizations, minimum working standards, and controls via direct and indirect supervisions, which will be elaborated later on.

#### 4.1.1. The role of the Agency in the preservation and stability improvement in the banking system

Some of the Agency's jurisdictions determining its role as preventive controllers will be regarded in terms of issuing approvals for the foundation of banks and other financial organizations of the banking system and its regulatory role in estimating minimum standards for activities, risk mitigation, and other standards crucial for the preservation, improvement and stability of the overall banking system, along with the client protection. During preventive controls, the Agency performs the following:

<sup>25</sup> Škrbić, S. (2014). *Savremeno bankarsko pravo u uslovima globalizacije i deregulacije posmatrano sa aspekta bankarskog prava Republike Srpske* (magistarski rad). Banja Luka: Fakultet pravnih nauka Panevropskog univerziteta Apeiron, 75.

<sup>26</sup> Vasiljević, Vasiljević, Malinić, 60.

(1) Meeting requirements for work licenses for banks and other financial organizations, which is also a requirement for entering the business entity court register. The Agency issues approval for banks' work in cases of the following: the bank meets the requirements set forth by the Law on Banks of the Republic of Srpska and its perspective for future financial condition is documented. In the work license, the Agency states the exact banking activities that the bank will perform.

(2) The Agency issues the license for any organizational changes in banks, including changes of activities, based on the review of requirements and upon the approval of the bank action emission.

(3) The Agency set forth standards for deposit assurance which a bank must meet.

(4) The preventive control by the Agency upon a bank's foundation and activities refers to issuing consent to the bank's Statute, nomination of the president and members of the Supervising Board, manager, vice-manager, and executive manager for the bank's credit board.

(5) The preventive control by the Agency also refers to estimating minimum standards for managing the bank's funds and capital protection as adopted by the Agency's Steering Board.<sup>27</sup>

(6) The Agency determines the manner, quality and adequacy of management, supervision and steering of the banks, which compels bodies of management, supervision and steering to timely adopt and control the application of preventive measures and activities focusing on the decline in a bank's business quality.

(7) A special Decision by the Agency's Steering Board determines the minimum standards for risk management in terms of banks' liquidity,<sup>28</sup> and defines a bank's management obligation to continuously design projections of future income and outcome based on the exact and updated register of all accountant operations and the adequate information system based on the bank's accountancy.

(8) The preventive control of the Agency is also pertinent in setting minimum standards for credit risk management, the amount and classification of bank's assets, the level of collectability, and risk concentration as defined by a special Decision on minimum standards for credit risk management and asset classification.<sup>29</sup>

(9) During preventive controls, the Agency estimates the adequacy of protection from interest rates, foreign currency, non balance, and other risks, sets forth minimum standards for foreign currency risk management, operative risk management, and minimum standards for market risk management.

(10) Within special jurisdiction, the Agency may initiate the procedure of confiscation of assets, business books and documentation of each individual, legal entity or body that willingly avoids or attempts to avoid the blocking order or to liquidate business activities of the individual, legal entity or body.

(11) In order to protect the right and interests of consumers- individuals who use banking services, the Ombudsman for the banking system was established within the

<sup>27</sup> Decision on minimum standards for bank capital management and capital protection, *Official Gazette of the Republic of Srpska*, No. 57/14.

<sup>28</sup> Decision on minimum standards for bank liquidity risk management, *Official Gazette of the Republic of Srpska*, No. 12/03.

<sup>29</sup> Decision on minimum standards for credit risk management and asset classification, *Official Gazette of the Republic of Srpska*, No.49/13 and 1/14.

Agency, which, among other things, proposes activities to improve relations between financial organizations of the banking system and users of the services provided by these financial organizations

4.1.2. The control role of the Agency in the business of financial organization of the banking system

The Agency continuously monitors the operations of banks and other financial organizations of the banking system, using methods of (1) indirect supervision; (2) direct supervision; (3) issuance of appropriate acts in accordance with their powers, and (4) determination of corrective measures.<sup>30</sup>

#### 4.1.2.1. Indirect supervision of the Agency

The Agency carries out indirect supervision continuously by collecting and analyzing reports, other documentation and information, as well as monitoring and verification of other data on the operations of financial organization of the banking system, which are obliged to report to the Agency on their operations in accordance with a special Decision of the Agency<sup>33</sup>, which prescribes the form and the content of the annual, semi-annual, quarterly and monthly reports on bank operations. The aforementioned Decision stipulates that the bank's report contains data on: the structure of the shareholder's capital according to the criteria of the country of origin, the qualification structure of the employees, financial indicators of the bank's operations with data on the balance sheet of assets and liabilities, data on capital and capital adequacy, asset quality, income statement, liquidity, data on the state of total loans and deposits, the state of loans and deposits secured by a foreign exchange clause, data on transactions on domestic payment transactions.

In addition to submitting regular reports on its operations, the bank is also obliged to submit to the Agency a monthly statistical report on executed transactions that are known or can be assumed to be prohibited according to the regulations governing the area of prevention of money laundering and financing of terrorist activities.

For the purpose of continuous indirect supervision, the Agency is authorized to request other data and information about the operations of banks, and the Agency obtains certain information and data on the basis of external and internal auditor's reports, other forms of correspondence with banks, statements submitted by banks at the Agency's request, and other available information, reports and notifications about a particular bank. Based on the collected data and information, the Agency compiles an analysis of each bank's operations individually, which specifically includes: assessment of capital adequacy, asset quality, profitability and liquidity, and dealing with legal restrictions.

With this form of control, the Agency draws up a record of the performed control only when irregularities and illegalities in the bank's operations have been determined during the control process, including untimely or incorrect submission of prescribed reports or the existence of a basis for taking a certain control measure.

In the same way, the Agency performs indirect supervision of the operations of microcredit organizations, savings and loan organizations and leasing companies, and the form and content of the report for each of these financial organizations is determined by the Agency in a separate decision.

<sup>30</sup> Drljača, Maričić, 45-58.

#### *4.1.2.2. Direct supervision of the Agency*

Direct supervision (on-site supervision) is carried out by authorized officials of the Agency by reviewing the bank's operations at the bank's headquarters or business unit, as well as in other places in cases prescribed by law. Direct supervision includes the use of financial reports and other data available to the Agency and the establishment of an interactive relationship between authorized persons of the Agency and the bank, which enables a detailed assessment of the bank's operations, an insight into the procedures used by the bank, the work of internal control and the bank's actions in accordance with legal regulations and the regulations of the Agency.

This form of supervision is carried out by: (1) reviewing accounting documents, business books, auxiliary and other records and calculations, reports that the bank is obliged to prepare, reviewing policies and reviewing other internal acts, and other documentation related to the bank's operations, including supervision of accounting programs; (2) checking the professional, organizational and technical equipment of the bank and (3) obtaining written and oral explanations from the management and supervisory board of the bank or other persons employed in the bank.

A controlled bank or other financial organization in the structure of the banking system has the right to lodge an objection within 15 days from the date of receipt of the minutes, disputing the findings from the minutes on established irregularities and weaknesses in business operations. If the bank does not submit an objection to the record within the prescribed period, or does not reasonably dispute the findings from the record, which established irregularities and weaknesses in the business, the Agency imposes an appropriate supervisory measure on the bank.

#### *4.1.2.3. Issuing adequate documents and undertaking surveillance measures*

In carrying out the supervisory function of bank operations, the Agency can pass appropriate acts depending on the established irregularities in the bank's operations, such as: a decision on a written warning to a member of the bank's management; prohibition of concluding contracts with users of banking services; the decision on convening the bank assembly; the decision on the dismissal of the management body; the decision on the appointment of bank advisors; decision on the introduction of a temporary manager; the decision on the appointment of a special administration in the restructuring process, and some other decisions depending on the established factual situation and the degree of irregularities in the bank's operations.

The supervisory measures that the Agency can undertake against the bank when it determines that the bank has acted contrary to the provisions of the Law, the Agency's regulations, other regulations or prudent banking standards, are: (1) issuing a written warning; (2) ordering the bank to eliminate irregularities and illegalities in business operations; (3) limiting the rights of shareholders with a qualified majority; and (4) undertaking early intervention measures, e.g. to order the bank's management authorities to implement one or more measures determined in the recovery plan, to require the bank's management authorities to analyze the situation, determine measures to solve identified problems and develop an action plan to solve those problems, to appoint an adviser or to make a decision on the introduction of the temporary administration in the bank, to require the bank to change its organizational structure, develop a debt restructuring plan, and some other early intervention measures.

The most rigorous measures in direct supervision that the Agency can impose are: confiscation of work permits; initiation of compulsory liquidation proceedings; submission of a proposal for the opening of bankruptcy proceedings and the initiation of the procedure for assessing the fulfillment of the conditions for the initiation of the restructuring procedure, when the Agency determines that the bank's condition is such that the bank cannot or probably will not be able to continue operations.

When determining the measures of supervision, the legislator determined that the Agency may determine the measure of supervision based on a discretionary assessment depending on the severity of the irregularities and illegalities, the demonstrated readiness and ability of the bank's authorities to eliminate the irregularities and illegalities, and the assessment of the degree to which the bank threatens financial discipline and smooth functioning banking system. For example, when assessing the severity of irregularities and illegalities established in the bank's operations, the Agency particularly assesses: the financial position of the bank, the degree of capital adequacy in relation to the risks undertaken, the impact of the committed irregularities on the future position of the bank, the duration and frequency of the committed irregularities and illegalities, and the legality of the bank's work in general.

Supervision measures in accordance with the Law on General Administrative Procedure are determined by the Agency in a decision, which is final, with the right of the bank to initiate the procedure for assessing the legality of the decision in an administrative dispute.

In addition to the determination of supervision measures, the Agency has the authority to issue a fine with a misdemeanor order or to file a request to initiate misdemeanor proceedings against the bank in accordance with the regulations governing misdemeanor proceedings.

#### **4.2. Internal bank control**

The legal obligation of banks is to establish an effective system of internal controls for monitoring risks, efficiency and effectiveness of operations, reliability of its financial reports and other information, and compliance of bank operations with regulations, internal acts, principles and standards of the profession.

An effective internal control system includes: (1) establishing and maintaining an adequate organizational structure; (2) establishment of control functions of the bank; (3) adequate control activities and division of duties; (4) appropriate internal controls integrated into the bank's business processes and activities; and (5) establishing and maintaining appropriate administrative and accounting procedures.

Internal control performs advisory activities aimed at improving the existing system of the bank. The members of this organizational unit of the bank apply a systematic, disciplined and documented approach to evaluating and improving the existing method of risk management, control and process management.

The basic task of internal control is to: ensure that risks are appropriately identified and controlled; identify weaknesses in the bank's operations and its employees; in case of non-fulfillment of obligations and exceeding of authority, prepare proposals for eliminating those weaknesses and recommendations for their elimination; regularly prepares reports on internal control activities and submits them to the bank's management, the board of directors, and the bank's business monitoring committee.

The bank is obliged to submit to the Agency an annual report on the adequacy of risk management and the bank's internal control, which contains statements: whether significant risks have been identified; whether the bank's internal control and risk management policies are adequate and whether they are effectively applied, whether an action plan has been established to eliminate deficiencies and whether the plan is being applied.

#### **4.3. Internal revision**

In addition to establishing an efficient system of internal control, it is a legal obligation for banks and other credit organizations to establish a special organizational unit of internal audit, which is independent in its work from other activities of the bank and other organizational parts of the bank. Employees in the organizational unit of the internal auditor may not perform management and other tasks related to the bank's activities, except tasks neither related to the performance of internal audits, nor may they participate in the preparation and drafting of acts and other documentation that may be subject to internal audit.

The bank's internal audit evaluates: (1) the adequacy of the risk management function and the business compliance function, in order to identify, monitor and control key risks, and to take appropriate measures to limit and mitigate them; (2) accuracy, correctness and reliability of the bank's accounting records and financial statements; (3) adequacy of the information system in the bank; (4) strategies and procedures for internal assessment of capital adequacy and internal assessment of liquidity adequacy; (5) the reliability of the reporting system, as well as the timeliness and accuracy of the reports prescribed by the Law on Banks of the Republic of Srpska and other laws, as well as regulations adopted on the basis of those laws; (6) system of collection and accuracy of information that is published publicly in accordance with the law; (7) management and protection of bank assets; (8) application of the bank's salary, compensation and other income policy; (9) assessment of weaknesses in the operations of the bank and its employees, as well as in cases of non-fulfillment of obligations and excess of authority; (10) actions of the bank according to the orders and recommendations of the Agency and the audit company; and (11) assessment of other bank operations prescribed by law and other regulations.

The organizational unit of the internal audit is obliged to provide the supervisory board and the bank's audit committee with an independent and objective opinion on the issues that are the subject of the audit, give advice and recommendations for improving the existing system of internal controls and the bank's operations, as well as provide assistance to the supervisory board and the board for audit in achieving their goals, applying a systematic and documented approach to improving the existing control, risk management and process management methods.

#### **4.4. External revision**

In addition to the mandatory establishment of internal control and internal audit, external audit is also of great importance as a form of external supervision that is carried out in accordance with legal regulations, international auditing standards, other rules of the auditing profession and the Agency's by-laws.

We can define an external audit as an independent examination and expression of opinion on the accounting statements of the bank's business system, which is carried out in accordance with the contract on the appointment of the external auditor and its legal

and statutory obligations. Bearing in mind the basic elements and objectives of the external audit, we can conclude that the external audit has a complementary role in the control of bank operations, but that it cannot replace the direct control of the supervisor of the banking system, that is, the Agency.

The goal of hiring an external auditor is to confirm, based on his expert opinion, whether the bank's financial statements are prepared in accordance with the established financial condition of the bank, to ensure acceptance of the level of accuracy of the bank's financial statements and to confirm whether the bank's financial statements contain material operational inaccuracies banks.

The bank is obliged to hire an external auditor for each business year, with the prior consent of the Agency, who will audit the bank's annual financial statements, audit consolidated financial statements and regular audits for the needs of the Agency. In addition to the audit of the bank's financial statements and regular audits for the needs of the Agency, the bank is obliged to engage an external auditor to perform an audit of the information system in the bank and assess the state of the information system and the adequacy of its management, an audit in case of status changes of the bank, as well as other types of audits, i.e. examination of certain business processes and data related to the bank's operations in accordance with the special act of the Agency, which determines the subject and method of conducting a special audit.<sup>31</sup>

External auditing in banks can only be carried out by an audit company, if it meets the conditions and criteria that are more precisely determined by a special decision of the Agency, namely: (1) that it has a work permit issued by the Ministry of Finance of the Republic of Srpska and that the company is entered in the register of companies for auditing; (2) that there are at least three authorized auditors with a valid license working on an indefinite, full-time basis; (3) that in the team of auditors performing the audit in a certain bank, at least three members have at least three years of experience in performing audits of the bank's financial statements, if they are employed by an external auditor or engaged, on some other basis, by an external auditor; (4) that there are no legal restrictions for conducting the audit; and (5) to have published an annual report on transparency in accordance with the Law on Accounting and Auditing, while additional conditions and criteria for issuing consent for the appointment of an external auditor for auditing the information system and documentation are determined by the Decision on the Management of Information Systems in Banks and the Decision on conditions and procedures for issuing permits, approvals and consents to banks operating in the Republic of Srpska.<sup>32</sup>

## 5. CONCLUSION

The control of modern banking systems is based on the concept of prudential control, which means that the control of the banking system is not concentrated only in the competence of the supervisor - the public control body, but with a precisely defined scope of authority is also entrusted to the bank's authorities, and with the aim of accuracy of reports on financial operations financial organizations, as the third pillar of control, the system of external audit is applied, which is performed by a special expert, who is not employed within the aforementioned financial organizations where the external audit is performed.

<sup>31</sup> Decision on conducting external audits in banks, *Official Gazette of the Republic of Srpska*, No.116/17.

<sup>32</sup> Decisions available at: <http://www.abrs.ba> (1.6.2023).

This control system maintains the basic elements of the regulation of modern banking systems, and the goal is to preserve its stability and the stability of the operations of every financial organization in the structure of the banking system.

The control system of the banking system of the Republika Srpska, as in other modern banking systems, is organized according to the principle of prudential control, which is organized on three levels, which is realized: the control role of the Agency, which, in addition to controlling the operations of financial organizations in the structure of the banking system, according to the principle of supervision performs preventive control in order to preserve and strengthen the stability of the banking system, and to improve its safe, quality and legal operations, then the institutional control that is established in the bank, in the form of internal control and internal audit, while the third pillar of control of financial operations is designated as external audit, which is performed by specially qualified persons.

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## Značaj i uloga kontrolnih organa bankarskog sistema Republike Srpske

**Apstrakt:** Uspostavljanje otvorenih finansijskih tržišta i pružanje finansijskih usluga van nacionalnih granica, odredilo je utvrđivanja međunarodnih standarda u određenim segmentima bankarskog poslovanja i obavezu da se nacionalna bankarska regulativa prilagođava zahtjevima uklanjanja administrativnih ograničenja slobode kretanja kapitala i uspostavljanja mehanizama koji će obezbijediti sigurnost i stabilnost bankarskog sistema. Navedeni zahtjevi su i odredili regulaciju bankarskog sistema u tržišno orjentisanim državama i državama koje su prolazile ili se još uvijek nalaze u procesu tranzicije. U cilju očuvanja stabilnosti bankarskog sistema, naročito je značajna prudenciona kontrola, kao jedan od osnovnih elemenata regulacija sigurnosti, koja ima za cilj da osigura stabilnost i sigurnost bankarskog sistema, smanji mogućnost rizika u poslovanju finansijskih organizacija koje čine strukturu bankarskog sistema, pruži odgovarajuću zaštitu investitorima i korisnicima bankarskih usluga. U tom smislu, poseban akcenat u regulaciji savremenih bankarskih sistema, naglašen je kod uspostavljanja supervizora za bankarski sistem, koji vrši usmjeravanje i unapređenje rada banaka, kontrolu zakonitosti rada i održavanje propisanih standarda u radu, uspostavljanje institucionalne kontrole, koja se ostvaruje u kombinaciji sistema interne kontrole i interne revizije i, vaninstitucionalne kontrole, koja je prepoznata kao spoljna revizija. Cilj ovog rada je istražiti značaj i ulogu kontrolnih organa u bankarskom sistemu Republike Srpske, koji djeluju po metodologiji supervizije bankarskog sistema, koja je povjerena Agenciji za bankarstvo Republike Srpske, kontrolnim organima banke i vaninstitucionalnoj kontroli finansijskog poslovanja finansijskih organizacija u strukturi bankarskog sistema,, koju vrši spoljni revizor.

**Ključne riječi:** bankarski sistem, regulacija sigurnosti, javna kontrola, institucionalna kontrola.

