

PROGRAM INFORMATION DOCUMENT (PID)
APPRAISAL STAGE

June 22, 2014
Report No.: AB7587

Operation Name	First Programmatic Financial Sector DPL
Region	EUROPE AND CENTRAL ASIA
Country	Ukraine
Sector	Banking (100%)
Operation ID	P150677
Lending Instrument	Development Policy Lending
Borrower(s)	UKRAINE
Implementing Agency	Ministry of Finance, National Bank of Ukraine and Deposit Guarantee Fund
Date PID Prepared	June 12, 2014
Estimated Date of Appraisal	June 24, 2014
Estimated Date of Board Approval	July 31, 2014
Corporate Review Decision	Following the corporate review, the decision was taken to proceed with the preparation of the operation.

I. Key development issues and rationale for Bank involvement

The ongoing political, economic and security crisis is putting Ukraine's banking system under severe stress. As a sign of eroding public confidence, the banking system lost around 15.4 percent of Ukrainian Hryvnia (UAH) and 20.8 percent of foreign exchange (FX) retail deposits in the first five months of 2014. The situation is exacerbated by long-standing structural problems within the banking system, including an overhang of non-performing loans (NPLs) left from the 2008-09 crisis and weak governance in many domestically owned banks.

The authorities are committed to a prioritized reform program aimed at stabilizing the banking system and resuming sustainable financial intermediation. Given the current political and macroeconomic pressures, the immediate objective for the next three to six months is to restore and maintain public confidence and preserve the stability of the banking sector. Simultaneously, the new management of the National Bank of Ukraine (NBU) is pursuing supervisory and regulatory actions that should result in a more consolidated and resilient banking sector, and restart the flow of credit to the real sector in the medium run.

The authorities' banking sector stabilization and restructuring program focuses on five areas: (i) maintaining adequate liquidity via NBU instruments; (ii) conducting independent diagnostic studies of large and medium-sized banks to determine their financial condition; (iii) enforcing recapitalization /restructuring of banks that have capital shortfalls or other deficiencies based on the diagnostic studies; (iv) undertaking resolution of unviable banks through a properly resourced Deposit Guarantee Fund (DGF); and (v) strengthening the legal and supervisory framework to make the sector more resilient to future shocks. Although the program has not been recorded in a single policy document, its various elements have been articulated in decisions and

regulations issued by the NBU, DGF, and the Ministry of Finance (MOF), and are presented in the draft Letter of Development Policy attached to this document.

II. Proposed Objective(s)

The First Programmatic Financial Sector Development Policy Loan (FSDPL1) supports a program of high-priority reform measures in the banking sector, and is a part of the World Bank Group's broader crisis-response support package for Ukraine. The proposed FSDPL1 is the first in a series of two operations and is in the amount of US\$500 million. The objective of the proposed FSDPL series is to assist the authorities in: (i) strengthening the operational, financial and regulatory capacity of the Deposit Guarantee Fund (DGF) for the resolution of insolvent banks; (ii) improving the solvency of the banking system through implementation of bank recapitalization/restructuring plans and timely enforcement action; and (iii) strengthening the legal and institutional framework to improve resiliency and efficiency of the banking system.

III. Preliminary Description

FSDPL1 is the first of two lending operations in a programmatic series aimed at supporting high-priority financial sector reform measures. The operation is anchored in nine prior actions, structured around three pillars. The first pillar focuses on urgent actions that are necessary to minimize the risk of a loss of depositor confidence, through ensuring that the DGF can adequately perform its critical bank resolution and insured deposit payout functions. The second pillar focuses on ensuring that adequate solvency of banking system is maintained through implementation of bank specific recapitalization/restructuring plans in the medium term. Finally, the third pillar supports legal and institutional reforms necessary to improve the resiliency and efficiency of banking system in the longer term.

The design of FSDPL1 and the selection of prior actions are guided by the urgent need to stabilize the banking system. Given the present security and exchange rate pressures, it is critical for the authorities to maintain the confidence of depositors in banks through sound liquidity management by the central bank, clear public communications, and adequate capacity to deal with any failing banks. With the IMF program already supporting the NBU's efforts at liquidity management, FSDPL1 focuses heavily on strengthening the capacity of the DGF to handle insolvent banks in a timely and orderly fashion, with minimal disruption to public confidence. Besides the financial resources, the Bank's support for the sector through FSDPL1 is expected to serve as an important confidence building measure. Following the initial stabilization, FSDPL2 (planned for the end of the first quarter of calendar year 2015) will support the implementation of bank recapitalization and restructuring programs based on the findings of external diagnostic assessments initiated under the first operation.

IV. Poverty and Social Impacts and Environment Aspects

Poverty and Social Impacts

The measures supported by FSDPL1 focus on urgent actions that are necessary to minimize the potential impact of a full-blown banking crisis that would lead to an increase in poverty in Ukraine. Based on current projections, the expected contraction of the economy by 5 percent in 2014 could lead to an increase in poverty of 2.1 percentage points¹ (equivalent to more than 900,000 people) if all households were equally exposed to a shock. However, the increase in poverty would be much higher if poorer groups are less able to protect themselves from macro-economic shocks.² A banking crisis, if it were to occur, would cause economic conditions to further deteriorate and contribute to further increases in the poverty rate in Ukraine. Thus the policy measures supported in FSDPL1 that focus on urgent actions that are necessary to minimize the risk of a loss of depositor confidence are critical to containing an increase in poverty in 2014 and beyond.

The measures supported the FSDPL series specifically aim to protect depositors by strengthening the DGF that insures deposits up to a certain coverage limit in the case of a bank failure. This is critical to minimizing the potential increase in poverty. Protecting deposits in the banking system will be especially important for those that are poor and among the bottom 40 percent as they are the most vulnerable if their savings were lost due to a bank failure. According to the 2012 Household Budget Survey, 19 percent of poor households have savings in a financial institution in Ukraine, with those who were saving reporting to be saving 16 percent of their income. For the bottom 40 percent, 16 percent of households have savings in a financial institution, with those who were saving reporting that they saved 10 percent of their income. Data from the Global Financial Inclusion Database (FINDEX) for 2011 also highlights the crucial role that savings play in people's livelihoods, with 15 percent of individuals saving for emergencies (with no significant gender differences in this respect)³.

The improvements in the resiliency and efficiency of the financial sector that are the primary focus of the policy measures supported by FSDPL2 are expected to, among other things, increase access to financial services and strengthen poor people's livelihoods. According to the latest household budget survey, access to financial services has increased for the population as a whole from 17 to 21 percent from 2007 to 2012.⁴ This increase has also been recorded for the bottom decile (roughly equivalent to the poor) and for the bottom 40 percent: from 6 to 9 percent and from 10 to 14 percent, respectively. According to the survey data,

¹ This estimate is based on the 2012 absolute poverty line kept constant in real terms. Ukraine adopts multiple relative and absolute poverty lines, but this approach (anchoring in real terms the value of one of the official poverty lines) seemed the one which would most clearly capture the developments due to a shrinking economy.

² Experience with this type of simulations shows that their findings are only indicative, particularly if households have access to coping strategies such as selling of assets or access to remittances, which can be countercyclical. As the economic contraction is protracted, or as the size of the macroeconomic shock increases, however, the effectiveness of these strategies diminishes. The continued uncertainty in the region might further contribute to deterioration in living standards. Based on currently available information these simulations are the best guess on future poverty trends.

³ There are however gender differences in the pattern of usage of bank accounts, with for example women being more reliant than men on bank accounts to receive government transfers or remittances.

⁴ The survey presents information on cash expenses on financial services, and on cash expenses on purchases of shares, certificates, foreign currency and bank deposits. We report on the latter as more specific questions tend to provide more precise answers.

households who use these services spend a non-negligible part of their budget on them (11 percent in 2012). Thus improving the resiliency and efficiency of the financial sector could help to lower costs and free resources that poor households could allocate to other necessities.

No actions requiring a gender angle were identified given the nature of the reforms and the FSDPL1 targets; nevertheless the team will monitor all available sources of data to ensure that the project impacts do not reinforce gender inequalities.

Environment Aspects

The proposed FSDPL1 measures are not likely to have any significant effects on the environment, natural resources and forestry. The policy measures focus on legal, regulatory, and supervisory reforms to strengthen and further develop the financial sector, with no impact on the environment.

V. Tentative financing

Source:	(\$m.)
Borrower	0
International Bank for Reconstruction and Development	500
Total	500

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