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Report No: PAD1540

INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

PROJECT APPRAISAL DOCUMENT

ON A

PROPOSED LOAN

IN THE AMOUNT OF EUR 300 MILLION
(US$327.47 MILLION EQUIVALENT)

TO THE

BULGARIAN DEPOSIT INSURANCE FUND

WITH A GUARANTEE OF THE REPUBLIC OF BULGARIA

FOR A

DEPOSIT INSURANCE STRENGTHENING PROJECT (P154219)

FEBRUARY 25, 2016

Finance & Markets
EUROPE AND CENTRAL ASIA

CURRENCY EQUIVALENTS

(Exchange Rate Effective January 31, 2016)

Currency Unit	=	Bulgarian leva (BGN)
BGN 1.784	=	US$1
US$0.561	=	BGN 1
BGN 1.948	=	EUR 1
EUR 0.509	=	BGN 1
US$1.092	=	EUR 1
EUR 0.916	=	US$1

FISCAL YEAR

January 1 – December 31

ABBREVIATIONS AND ACRONYMS

AQR	Asset Quality Review
BCBS	Basel Committee on Banking Supervision
BCP	Basel Core Principles
BDIF	Bulgarian Deposit Insurance Fund
BGN	Bulgarian Leva
BNB	Bulgarian National Bank
BP	Bank Procedures
BRRD	Bank Recovery and Resolution Directive
CAP	Corrective Action Plan
CAR	Capital Adequacy Ratio
CP	Core Principles
CRD	Capital Requirements Directive
CRR	Capital Requirements Regulation
DA	Designated Account
DGSD	Deposit Guarantee Schemes Directive
DLI	Disbursement Linked Indicator
EBA	European Banking Authority
EBRD	European Bank for Reconstruction and Development
EC	European Commission
ECA	Europe and Central Asia
EU	European Union
FIB	First Investment Bank
FM	Financial Management
FSAC	Financial Stability Advisory Council
FSAP	Financial Sector Assessment Program
FSC	Financial Supervision Commission
FSCA	Financial Supervision Commission Act
GDP	Gross Domestic Product
GP	Good Practices
GRS	Grievance Redress Service

IADI	International Association of Deposit Insurers
IBRD	International Bank for Reconstruction and Development
ICR	Insolvency and Creditor Rights
IFI	International Financial Institution
IFR	Interim Financial Reports
IMF	International Monetary Fund
IPF	Investment Project Financing
IS	Implementation Support
KTB	Corporate Commercial Bank
LBB	Law on Bank Bankruptcy
LBDG	Law on Bank Deposit Guarantee
LCI	Law on Credit Institutions
MOF	Ministry of Finance
MOU	Memorandum of Understanding
NPL	Nonperforming Loan
OP	Operational Policies
PAD	Project Appraisal Document
PDO	Project Development Objective
PPO	Public Policy Objectives
ROA	Return on Assets
ROE	Return on Equity
ROSC	Reports on the Observance of Standards and Codes
SCD	Systematic Country Diagnostic
SOE	Statement of Expenditures
SORT	Systematic Operations Risk- Rating Tool
SSM	Single Supervisory Mechanism
SW	Staff Weeks
TA	Technical Assistance
WB	World Bank
WBG	World Bank Group
YR	Year

Regional Vice President:	Cyril Muller
Country Director:	Arup Banerji
Senior Global Practice Director:	Gloria Grandolini
Practice Manager:	Aurora Ferrari
Task Team Leader:	Alexander Pankov

BULGARIA
Deposit Insurance Strengthening Project

TABLE OF CONTENTS

Page

PAD DATA SHEET

Bulgaria

Deposit Insurance Strengthening Project (P154219)

PROJECT APPRAISAL DOCUMENT

EUROPE AND CENTRAL ASIA

Finance & Markets Global Practice

Report No.: PAD1540

Basic Information

Project ID P154219	EA Category C - Not Required	Team Leader(s) Alexander Pankov
Lending Instrument Investment Project Financing	Fragile and/or Capacity Constraints [ ]	
	Financial Intermediaries [ ]	
	Series of Projects [ ]	
Project Implementation Start Date 01-Apr-2016	Project Implementation End Date 30-Jun-2018	
Expected Effectiveness Date 01-Jul-2016	Expected Closing Date 31-Dec-2018	
Joint IFC No		

Practice Manager/Manager	Senior Global Practice Director	Country Director	Regional Vice President
Aurora Ferrari	Gloria M. Grandolini	Arup Banerji	Cyril E Muller

Borrower: Bulgarian Deposit Insurance Fund			
Responsible Agency: Bulgarian Deposit Insurance Fund			
Contact:	Radoslav Milenkov	Title:	Chairman of the Management Board
Telephone No.:	0035929531217	Email:	contact@dif.bg

Project Financing Data(in USD Million)

[X]	Loan	[ ]	IDA Grant	[ ]	Guarantee
[ ]	Credit	[ ]	Grant	[ ]	Other

Total Project Cost:	327.47	Total Bank Financing:	327.47
Financing Gap:	0.00		

Financing Source	Amount
Borrower	0.00
International Bank for Reconstruction and Development	327.47
Total	327.47

Expected Disbursements (in USD Million)

Fiscal Year	2016	2017	2018	2019	0000	0000	0000	0000	0000	0000
Annual	0	236.21	61.26	30.00	0.00	0.00	0.00	0.00	0.00	0.00
Cumulative	0	236.21	297.47	327.47	0.00	0.00	0.00	0.00	0.00	0.00

Institutional Data

Practice Area (Lead)

Finance & Markets

Contributing Practice Areas

Cross Cutting Topics

[ ] Climate Change

[ ] Fragile, Conflict & Violence

[ ] Gender

[ ] Jobs

[ ] Public Private Partnership

Sectors / Climate Change

Sector (Maximum 5 and total % must equal 100)

Major Sector	Sector	%	Adaptation Co-benefits %	Mitigation Co-benefits %
Finance	Banking	100		
Total		100		

☑ I certify that there is no Adaptation and Mitigation Climate Change Co-benefits information applicable to this project.

Themes

Theme (Maximum 5 and total % must equal 100)

Major theme	Theme	%
Financial and private sector development	International financial standards and systems	100
Total		100

Proposed Development Objective(s)
The Project Development Objective is to strengthen the financial and institutional capacity of the Bulgarian Deposit Insurance Fund (BDIF) so as to enable it to meet its deposit insurance and bank resolution obligations.

Components	
Component Name	**Cost (USD Millions)**
Deposit Insurance Strengthening	327.47

Systematic Operations Risk- Rating Tool (SORT)	
Risk Category	**Rating**
1. Political and Governance	Moderate
2. Macroeconomic	Moderate
3. Sector Strategies and Policies	Substantial
4. Technical Design of Project or Program	Moderate
5. Institutional Capacity for Implementation and Sustainability	Moderate
6. Fiduciary	Moderate
7. Environment and Social	Low
8. Stakeholders	Moderate
9. Other	
OVERALL	Moderate

Compliance		
Policy		
Does the project depart from the CAS in content or in other significant respects?	Yes [ ]	No [X]
Does the project require any waivers of Bank policies?	Yes [ ]	No [X]
Have these been approved by Bank management?	Yes [ ]	No [ ]
Is approval for any policy waiver sought from the Board?	Yes [ ]	No [X]
Does the project meet the Regional criteria for readiness for implementation?	Yes [X]	No [ ]

Safeguard Policies Triggered by the Project	**Yes**	**No**
Environmental Assessment OP/BP 4.01		**X**
Natural Habitats OP/BP 4.04		**X**
Forests OP/BP 4.36		**X**
Pest Management OP 4.09		**X**
Physical Cultural Resources OP/BP 4.11		**X**
Indigenous Peoples OP/BP 4.10		**X**

Involuntary Resettlement OP/BP 4.12		**X**
Safety of Dams OP/BP 4.37		**X**
Projects on International Waterways OP/BP 7.50		**X**
Projects in Disputed Areas OP/BP 7.60		**X**

Legal Covenants

Name	Recurrent	Due Date	Frequency
Deposit Insurance Legislation	**X**		Continuous

Description of Covenant

The Deposit Insurance Legislation has been amended, suspended, abrogated, repealed or waived so as to affect materially and adversely the ability of the Borrower to: (i) perform any of its obligations under this Agreement; or (ii) carry out its deposit insurance and bank resolution obligations.

Name	Recurrent	Due Date	Frequency
BDIF Reserves are less than the cumulative amount of the BDIF Transfers	**X**		Continuous

Description of Covenant

Exceptions: (i) payments in an equivalent amount made by the Borrower to fulfill its deposit insurance and bank resolution obligations, in accordance with the Deposit Insurance Legislation, not including repayment of funds borrowed from entities other than the Guarantor, or (ii) an investment loss, when the investments of BDIF Reserves were made in accordance with the Deposit Insurance Legislation.

Conditions

Source Of Fund	Name	Type
IBRD	Adoption of Project Operations Manual by the Borrower	Effectiveness

Description of Condition

The Additional Condition of Effectiveness consists of the following: namely that the Project Operations Manual has been adopted by the Borrower in a manner and with content acceptable to the Bank.

Team Composition

Bank Staff

Name	Role	Title	Specialization	Unit
Alexander Pankov	Team Leader (ADM Responsible)	Lead Specialist	Lead Specialist	GFM03
Blaga Djourdjin	Procurement Specialist	Procurement Specialist	Procurement Specialist	GGO03
Anneliese Viorela Voinea	Financial Management Specialist	Financial Management Analyst	Financial Management Analyst	GGO21

Gabriela Grinsteins	Team Member	Counsel	Country Lawyer	LEGLE
Isfandyar Zaman Khan	Team Member	Program Leader	Program Leader	ECCU5
Jan Philipp Nolte	Team Member	Senior Financial Sector Specialist	Senior Deposit Insurance Expert	GFMFO
Jasna Mestnik	Team Member	Finance Officer	Disbursement Specialist	WFALA
Raquel Alejandra Letelier	Team Member	Financial Sector Specialist	Financial Sector Specialist	GFM03
Stella Ilieva	Team Member	Senior Economist	Senior Economist	GMF03
Sylvia Nikolova Stoynova	Team Member	Operations Officer	Operations Officer	ECCBG

Extended Team

Name	**Title**	**Office Phone**	**Location**

Locations

Country	**First Administrative Division**	**Location**	**Planned**	**Actual**	**Comments**

Consultants (Will be disclosed in the Monthly Operational Summary)

Consultants Required? To be determined by project needs over time

I. **STRATEGIC CONTEXT**

A. Country Context

1. **After years of strong performance, Bulgaria's growth and convergence have slowed in recent years, exposing a number of structural challenges.** Between 2000 and 2008, Bulgaria's GDP per capita rose 6.1 percent a year on average, supported by a favorable external environment, increasing labor productivity, and, last but not least by sizable foreign capital inflows. However, between 2008 and 2014, the global financial crisis and subsequent Eurozone crisis led to annual growth in per capita income of just 1 percent, and today Bulgaria is still the EU member state with the lowest GDP per capita of around 45 percent of the EU average. Despite a significant reduction in public debt from nearly 100 percent of GDP in 1997 to one of the lowest in the EU, more can be done to make public spending more efficient and effective. Governance problems have undermined Bulgaria's economic progress, particularly in terms of the rule of law, control of corruption, and government effectiveness, while a challenging external environment and a declining and aging population have produced additional headwinds. Recent banking system instability (see section I.C.ii below) and a sharp deterioration in the country's fiscal stance (due to the support to the banking sector[1] and ad hoc increases in spending for pensions and health) are putting further strain on the economic outlook.

2. **Growth is projected to remain low due to subdued domestic demand, and relatively low levels of private investment.** Real GDP growth has stalled at around 1 percent per year after the contraction registered in 2009, although it has shown signs of acceleration since early 2013 with growth reaching 2.3 percent year-on-year in the second quarter of 2015. Weak domestic demand is expected to continue to weigh on growth in 2016, as adverse demographic developments and planned fiscal consolidation are likely to limit the increase in disposable income. Investment in the economy remains low and gross fixed capital formation has stayed broadly flat in real terms since 2009. Private sector investment has been declining since 2009[2], and is only expected to stabilize in 2016, assuming the internal and external environment remain relatively stable. Government investment has been the main driver of gross capital formation post-crisis, mostly linked to the absorption of EU Structural Funds, but a decline is expected in 2016 as the 2007-2013 programming period comes to an end, and the new one (2014-2020) has yet to gather speed.

B. Situations of Urgent Need of Assistance or Capacity Constraints (if applicable)

N/A

[1] The general government deficit for 2014 was recalculated at 5.8 % of the country's GDP in October 2015, more than double the original estimate, due to reclassification of the Deposit Insurance Fund inside general government.
[2] Positive growth was only registered in 2012.

C. Sectoral and Institutional Context

i. Banking Sector Structure and Performance

3. **The banking system is primarily foreign owned, with an important presence of Greek banks, but there is a sizeable domestically owned segment.** There are 28 banks operating in the country, 12 of which are subsidiaries of foreign banks, and 6 are branches of foreign banks, together representing 75.7 percent of total bank assets as of December 2015. There is 1 state-owned bank and 1 municipality-owned bank, together representing 3.2 percent of total assets. The top five banks in Bulgaria have a market share of 57.3 percent of total bank assets, with the largest two owned by Italian and Hungarian parents, with 19.8 percent and 12.7 percent market shares, respectively. However, by country of origin, Greek-owned banks are also important as collectively they have the third largest presence in the country, with 4 banks having a combined asset share of 18.6 percent, including the 4th and 6th largest. There are 8 other domestically owned banks with a combined asset share of 21.1 percent, including the third largest bank (First Investment Bank (FIB)).

4. **The banking sector shows relatively high levels of financial depth.** Assets and loans to GDP as of November 2015 stood at 104 percent and 60.1 percent respectively (Figure 1), which is relatively high by regional standards (for example, Hungary, Poland and Romania have assets and loans to GDP ratios below 100 and 60 percent respectively). Deposits to GDP are also relatively high at 73.7 percent of GDP.

5. **As the Bulgarian banking system is largely foreign owned, it has been exposed to deleveraging pressures, which nevertheless have been compensated by greater mobilization of domestic funding.** Bulgaria was not immune to the deleveraging pressures experienced by other countries in the region, as banks' foreign liabilities declined by an equivalent of 18.4 percent of GDP from the peak in 2008 (Figure 2). However, domestic deposit mobilization increased by 22.6 percent of GDP during the same period, enough to compensate the loss of foreign funding, driven by households' high propensity to save.

Figure 1. Financial depth (% of GDP), November 2015

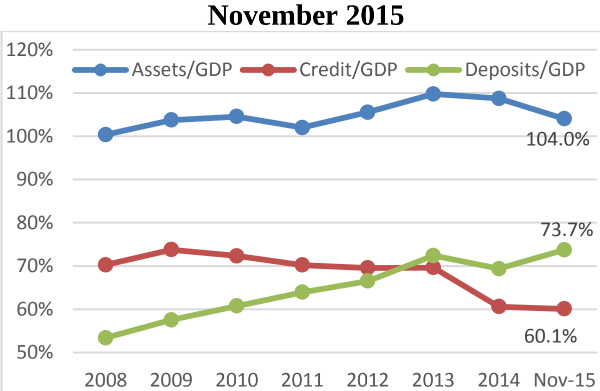
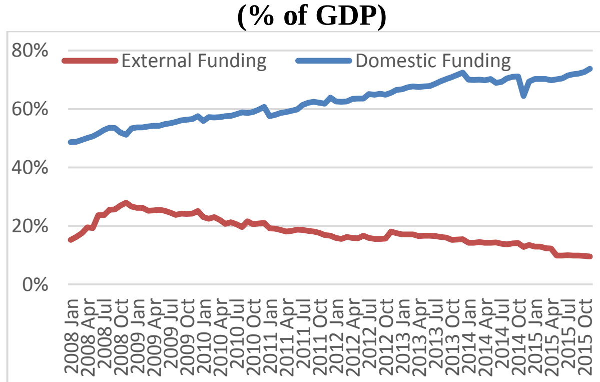


Figure 2. Banks' external and domestic funding (% of GDP)



Source: IFS, BNB, WEO.

6. **The funding structure of banks is primarily deposit-based.** Total customer deposits represent 75 percent of total liabilities (including equity), followed by capital and reserves (13 percent), interbank deposits (10 percent) and subordinated debt (0.6 percent). Other types of borrowing represented only 0.4 percent of total funding sources.

7. **Capital adequacy is relatively sound, but may mask significant differences between banks.** As of September 2015, Tier 1 and total capital adequacy ratios for the system were high, at 20.5 percent and 22.3 percent, respectively (Figure 4), although there is significant variation among individual banks. The ratios have increased markedly since end-2013 due to the EU's Capital Requirements Regulation and Directive (CRR/CRD IV) implementation, as "specific" provisions are no longer deducted from regulatory capital.

8. **Credit growth has been subdued in recent years due to weak economy and legacy of non-performing loans (NPLs).** Private credit grew just 0.1 percent year-on-year in 2013, lower than previous years, as a consequence of a weak economy. During 2014, credit growth accelerated to around 2 percent, but the effects from the failure of KTB (see below) and uncertain economic outlook weighed negatively on the demand for loans (corporate and households) with credit growth turning negative since November 2014, challenging banks' ability to generate profits from this core activity. In addition, the long-standing asset quality problem is not helping jumpstart credit growth in a sustainable manner. The NPL ratio (loans overdue by more than 90 days to non-financial corporations and households) stood at 15.9 percent in end December 2015. However, the entire stock of NPLs could potentially be covered by the banks' capital surplus (i.e., capital in excess of the regulatory requirements).

9. **The sector liquidity is high, reflecting the inflow of deposits and the lack of credit growth.** The ratio of liquid assets to total assets has steadily increased reaching 36.7 percent by December 2015 (Figure 3), despite the temporary liquidity difficulties faced by some banks following the failure of KTB in mid-2014.

10. **Despite the weak credit growth and high liquidity levels, the sector has been able to maintain profitability due to wider lending-deposit spreads.** ROA of 1.03 percent in 2015 has improved somewhat in comparison to previous years, while profits rose by 20.4 percent year-on-year in 2015. Banks' efforts to reduce deposit rates (from around 3 percent at end-2014 to around 1.5 percent as of December 2015) have not yet translated in a similar reduction in lending rates (standing at an average of 8.6 and 5.2 percent for households and corporates, respectively), particularly for foreign currency loans (representing roughly half of total loans and almost entirely denominated in euro as the reserve currency) and household lending (representing close to 40 percent of total loans). Therefore, current profits are largely due to a wider spread between lending and deposit rates, rather than resulting from generation of new credit.

Figure 3. Liquid assets to total assets (%)

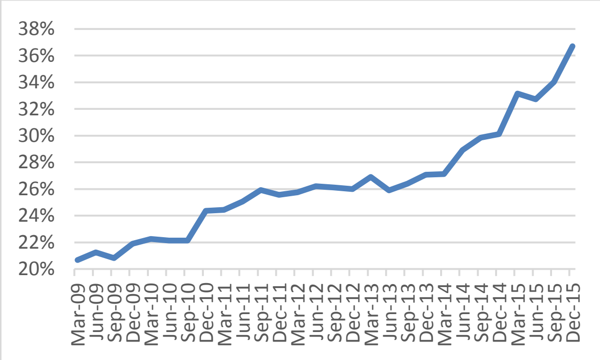
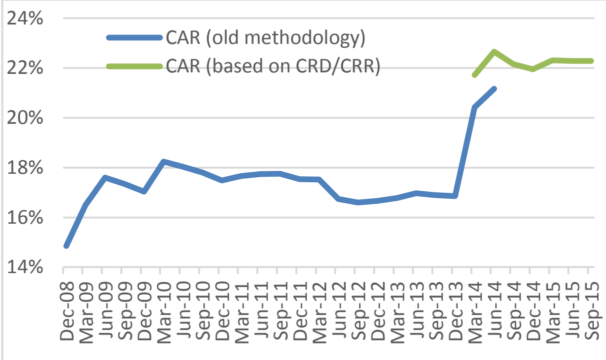


Figure 4. Capital adequacy ratio (%)



Source: BNB

11. **Greek subsidiaries have been losing market share and face an uncertain future, but do not represent an immediate in terms of contagion risks.** The three Greek subsidiaries and one branch had an asset share of 23.1 percent as of end-2014, and were the largest presence by country in the Bulgarian banking sector. However, given the difficulties faced by their parents in Greece, subsidiaries have been losing market share and are now the third largest presence by country of origin (after domestically owned banks and a single Italian bank) with a combined 18.6 percent asset share as of December 2015. The announced merger between the remaining branch and one of the other Greek subsidiaries will further consolidate the Greek presence to three banks among the top 10 by asset share[3], but their future remains uncertain, given that the parents may have to sell them eventually as part of their restructuring plans. Meantime, the introduction of capital controls in Greece in mid-2015 did not have any marked spillover effect in Bulgaria given the banks' ample liquidity buffers and the well-coordinated public communication by the authorities.

ii. *The failure of Corporate Commercial Bank and the role of Bulgarian Deposit Guarantee Fund*

12. **In June 2014, Corporate Commercial Bank (KTB) was put under conservatorship after a large deposit run.** At that time KTB was the country's 4th largest bank by assets, which had long pursued an aggressive funding strategy. After KTB had lost BGN 1.2 billion (€600 million; around 20 percent of its total deposits) in a matter of days, the Bulgarian National Bank (BNB) placed KTB under special supervision regime on June 20, 2014. Within days, First Investment Bank (FIB) -- the 3rd largest bank and the largest domestically owned bank – also faced a deposit run, losing about 10 percent of its deposits on a single day as liquidity pressures were threatening to spread to the rest of the banking system.

[3] Parent banks of Greek subsidiaries are undergoing restructuring, and on July 17th, 2015, the acquisition of Alpha Bank's Bulgarian branch (currently the 17th largest bank by assets) by Eurobank Bulgaria (currently the 6th largest) for €1 has been announced. The transaction is expected to be finalized in 2016, upon which Eurobank Bulgaria will become the 4th largest bank in Bulgaria.

13. **To avoid further negative spillovers, the authorities announced an urgent package of measures to preserve stability in the banking system.** The cornerstone was a liquidity assistance scheme (approved by the European Commission in June 2014) that provided for 5-month state deposits at market conditions to solvent banks. Liquidity support was provided by the Government as the BNB's capacity to act as a lender of last resort is constrained due to the long-standing currency board arrangement. The only beneficiary of the scheme was First Investment Bank, which was granted a state deposit of BGN 1.2 billion (€613.6 million). In November 2014, the Government notified the European Commission about extension of the liquidity support to FIB until May 2016.[4] The liquidity support scheme, coupled with consistent messages to the public, helped to reverse the outflow of deposits.

14. **Limited range of resolution tools resulted in lengthy conservatorship period for KTB during which depositors did not have access to their savings.** According to the then existing provisions of the Law on Bank Deposit Guarantee (LBDG), the Bulgarian Deposit Insurance Fund (BDIF) could only start reimbursing depositors once the banking license of a failed institution is withdrawn. This led to a five months delay with payout to insured depositors, due to which Bulgaria was officially notified by EC in September 2014 to be in infringement of the EU rules.[5]

15. **The BNB finally revoked KTB's license in November 2014 on the basis of its insolvency, thus triggering the payout of insured deposits.** Based on the results of an assessment carried out by external auditors, KTB was estimated to have a negative capital of BGN -3.8 billion (€-1.9 billion) and CAR of -180.2% as of end September 2014. The audit also revealed imprudent lending practices and mismanagement of credit files, and a significant portion of the loan portfolio was associated with related-parties. The decision on license revocation unlocked the payout of KTB's BGN 3.7 billion (€1.9 billion) of insured deposits (for up to BGN 196,000, or €100,000 per depositor) by the BDIF. Meantime, following the court procedure, KTB has entered bankruptcy procedure under the BDIF's oversight in April 2015.

16. **Payout of KTB's insured deposits put a severe strain on BDIF's financial capacity.** Prior to KTB's failure, the BDIF had accumulated, by collecting annual premiums from commercial banks, total reserves of BGN 2.1 billion (€1.07 billion). In order to bridge the funding gap, in December 2014 the Government provided the BDIF with a loan of up to BGN 2 billion (€1 billion), with a maturity of up to 5.5 years, at a fixed interest rate of 2.95 percent. As of end February 2015, the BDIF had reimbursed, through its agent banks, around €1.9 billion (> 95 percent of KTB's insured deposits) to 101,740 insured depositors[6]. Only BGN 200 million

[4] The terms of the scheme were set in line with EU state aid rules. FIB presented a restructuring plan to the European Commission, including a set of commitments to restore liquidity as well as to improve its corporate governance and risk management policies.

[5] At that time, the EU rules required that the payout should start within 20 working days from the moment of determination of competent authority of the unavailability of the deposits. The infringement case was subsequently dropped with the transposition of EU Directives in the national legislation (see section iii. below).

[6] During the first 20 business days, over 90 percent of insured deposits were paid out, showing the effectiveness of the preparatory work and the capacity of BDIF to undertake a swift payout to insured depositors.

(€100 million) were left in BDIF's reserves at that time, although an additional BGN 258 million (€132 million) came in as annual premium at the end of March 2015.

iii. Recent Measures to Strengthen Financial Stability

17. **The failure of KTB highlighted corporate governance problems in the banking sector, and exposed weaknesses in bank supervision and resolution regime.** The crisis revealed a number of institutional weaknesses in the BNB's supervisory framework as it failed to take action prior to the collapse of KTB. It also gave rise to doubts about the health of other banks. Finally, the crisis exposed a number of deficiencies in the legal and institutional framework for bank resolution and deposit insurance, and depleted the reserves of the deposit guarantee scheme.

18. **As part of immediate policy response, Bulgaria announced its plans to conduct a comprehensive asset quality review (AQR) and stress tests of the entire banking system.** Bulgaria manifested its interest in joining the EU's Single Supervisory Mechanism (SSM) as part of the package of measures announced by the authorities shortly after the deposit run in KTB, in an attempt to restore confidence in the market. As a pre-requisite for joining the SSM, the BNB committed to undergo a comprehensive asset quality review (AQR) and stress testing of all Bulgarian banks, based on the ECB methodology. The whole exercise is set to be completed within 12 months of the enactment of the Act on Recovery and Resolution of Credit Institutions and Investment Firms, i.e., by August 2016. In July 2015, the governing council of the BNB launched a tender for selecting an independent external consultant to help with the development of methodology and then overseeing the AQR exercise. Bids were submitted by three consulting companies, and the final selection was made in end-October 2015.

19. **In parallel, the authorities have also completed the transposition of EU's recent financial sector directives into national legislation.** Of particular importance is the transposition of the EU's Bank Recovery and Resolution Directive (BRRD), with relevant amendments to the BNB Law, the Law on Credit Institutions (LCI), and the Law on Bank Bankruptcy (LBB). The new Law on Recovery and Resolution of Credit Institutions and Investment Firms was enacted on August 14th, 2015, while a new Law on Bank Deposit Guarantee, which transposes the EU's recent Directive on Deposit Guarantee Schemes (DGSD), was enacted on the same day. The authorities are currently working on the implementation of both acts.

20. **Under the new EU resolution framework that Bulgaria has just transposed, banks deemed "public interest" will be resolved.** In accordance with the EU's BRRD, the new Bulgarian resolution law requires banks to prepare recovery plans to overcome potential financial distress. Authorities are also granted a set of powers to intervene in the operations of banks in order to minimize the risk of failure. If a bank faces imminent failure, authorities are equipped with comprehensive powers and tools to "resolve" (i.e., restructure) it in a way that

preserves the most critical functions and minimizes the use of public funds. This resolution technique is meant for larger banks (so-called banks of public interest), while smaller institutions would be subject to normal bankruptcy/liquidation procedures.

21. **The cost of resolution will be funded from bail-in and Resolution Fund set at the national level, while deposit insurance scheme will contribute to the cost of resolution up to a specified limit.** Resolution costs will normally be covered by imposing losses (so-called "bail-in") on bank shareholders and creditors. If required, resources of the newly established Resolution Fund, financed by bank contributions, will be utilized to finance the cost of resolution. Finally, deposit insurance fund may contribute to the financing of resolution up to the smaller amount between the amount of net losses that insured depositors would bear in case of insolvency in accordance with the ranking of creditors, and the amount of available funds at the deposit insurance fund.

22. **The institutional set up for resolution gives BDIF a number of additional functions and responsibilities related to the implementation of resolution decisions taken by the Resolution Authority.** The new law designates the BNB as the Resolution Authority for banks, while any resolution that entails the use of public finances will have to be approved by the Ministry of Finance. The BDIF will be responsible for managing the Resolution Fund, in addition to the deposit insurance fund. BDIF is also given the function of establishing, upon the decision of the Resolution Authority, and operating bridge banks which would be funded by the Resolution Fund.

23. **The new Law on Bank Deposit Guarantee significantly reduces the timeframe for depositor payout.** According to the new law, the payout of insured deposits must start within seven business days after a bank's license is revoked or the BNB declares the unavailability of deposits. The target level of the deposit insurance fund is set at 1 percent of covered deposits to be reached by 2024 (at the latest), while annual premium contributions will be determined on the basis of the amount of covered deposits and the degree of the risk assumed by the relevant bank (risk-based premiums).

24. **The Bulgarian authorities have also requested the WB and the IMF to conduct a Financial Sector Assessment Program (FSAP) update[7], with two advance modules on banking supervision and deposit insurance already completed.** The main FSAP mission is expected to take place in the second half of 2016, following the completion of AQR exercise. However, two advance modules on priority topics have already been carried out in 2nd quarter of 2015: (i) a WB assessment against Core Principles for Effective Deposit Insurance Systems established by the International Association of Deposit Insurers (IADI); and (ii) a joint WB-IMF assessment against Basel Core Principles (BCP) for Effective Bank Supervision.

25. **The IADI assessment concluded that while Bulgaria has a relatively well-developed framework for deposit insurance, the BDIF's financial strength needs to be promptly**

[7] The last FSAP update was carried out by the WB and the IMF in 2008, but did not include a BCP assessment.

rebuilt. The new deposit insurance law mentioned above addresses some of the main recommendations from the IADI assessment. The proposed Project aims specifically to support the BDIF in implementing the provisions of the new law, and restoring the BDIF's financial capacity (the summary of assessment results can be found in Section VI.B).

26. **The assessment against Basel Core Principles for Effective Bank Supervision identified weaknesses in several important areas.** Out of the 29 principles, 9 were assessed as compliant, 12 as largely compliant, 8 as materially non-compliant, and 0 as non-compliant. The materially non-compliant principles refer to areas such as the internal governance of BNB, limited powers of BNB over bank shareholders not meeting requirement for holding equity in banks, insufficient corrective and sanctioning powers of BNB, weaknesses in corporate governance of the banking sector, shortcomings in the supervision of concentration risk and large exposure limits, insufficient regulation on transactions with related parties, lack of regulation on country and transfer risks, and limited powers of BNB with respect to selection and oversight of external auditors. It is worth noting that BNB has chosen to disclose the full text of assessment report to the public.

27. **Based on the BCP assessment, the BNB has recently outlined an action plan for improving the effectiveness of banking supervision.** The plan, published in early October 2015, includes specific measures to be completed by end 2016 in order to address identified weaknesses in the following six areas: (i) inadequate governance model to exercise BNB's supervision functions, (ii) weaknesses in the internal organization of BNB's Banking Supervision Department, (iii) incompleteness in regulatory acts, internal rules and guidelines regulating banking supervision, (iv) absence of an institutional framework for crisis management and bank resolution, (v) deficient IT and communication support for supervisory functions, and (vi) insufficient coordination and information exchange with other institutions relevant to the supervisory function.

28. **The broad set of reform announced by the new leadership team at the BNB demonstrate a strong commitment to strengthen the bank supervision and resolution regime.** In particular, the BNB Governing Council will start receiving more information on supervision activities and have more control mechanisms at its disposal. A new Offsite Supervision Directorate and an internal advisory council to the Deputy Governor in charge of the Banking Supervision Department are being established. The number of inspection teams will be increased, and a new Division under the Special Supervision Directorate is set up to analyze market behavior and related risks. Draft legislative amendments will be prepared to expand the power to exert supervisory measures, while a full review or ordinances, internal rules and guidelines regulating supervision activities will be conducted. A new Bank Resolution Directorate outside the Banking Supervision Department is being established, while requirements and processes for preparation and approval of recovery plans, and rules and procedures for early intervention will be specified. Finally, BNB has committed to sign

memoranda of coordination and information exchange in relation to supervisory activities with other institutions, including the BDIF.

29. **The authorities are expanding cooperation with international financial institutions in support of financial sector reform.** In addition to the planned WB/IMF FSAP and the discussions with the WB and the EBRD on strengthening the BDIF, the BNB has recently asked the IMF and the WB to assist in implementing the priority recommendations from BCP assessment. The authorities have also requested the WB to conduct a comprehensive assessment of the country's regime for insolvency and creditor rights (ICR ROSC), in order to identify obstacles to the faster resolution of NPLs. At the level of financial institutions, the IFC is implementing a corporate governance TA project with domestically owned First Investment Bank, which has already resulted in the appointment of independent board members.

D. Higher Level Objectives to which the Project Contributes

30. **The proposed project is fully consistent with the Systematic Country Diagnostic (SCD)[8] which calls for safeguarding macroeconomic and financial stability.** In order to restore confidence and attract private investment, addressing weaknesses in banking regulation and supervision are identified as critical priorities for the government in the short and medium term. The SCD states that, while transposing relevant EU Directives into national legislation would provide a good anchor for reforms, it is also necessary to enhance the governance and institutional capacity of all the institutions responsible for financial stability, such as the BDIF, bank and non-bank financial supervision. The project is also in line with the SCD's focus on protecting the more vulnerable parts of population, as it will help safeguard the savings of small individual depositors.

31. **The proposed project also contributes to the World Bank's twin goals insofar as financial stability is essential for achieving sustainable growth and shared prosperity.** As shown by experience from the global financial crisis, bank failures have been found to be most damaging for small firms and poor households. Ensuring that the BDIF has adequate financial and institutional capacity helps increasing confidence of depositors in the banking system, which in turn stimulates higher domestic savings that can be utilized for investments leading to job creation and shared prosperity. In addition, greater financial stability translates into a lower burden on government finances, which in turn reduces the likelihood of a fiscal crisis, thus allowing the government to continue to provide basic services to all citizens, including the poor who rely heavily on such services.

[8] Bulgaria's Potential for Sustainable Growth and Shared Prosperity, September 2015, the World Bank Group.

II. PROJECT DEVELOPMENT OBJECTIVE

A. PDO

32. **The Project Development Objective is to strengthen the financial and institutional capacity of the Bulgarian Deposit Insurance Fund so as to enable it to meet its deposit insurance and bank resolution obligations.**

Project Beneficiaries

33. **The direct beneficiary of the Project is the BDIF**. According to the current Law on Bank Deposit Guarantee, the BDIF is a public legal entity in charge of protecting insured deposits and participating in the preservation of financial stability. BDIF is governed by a five-person Management Board (including members nominated by the Council of Ministers and the BNB). BDIF is accountable to the Council of Ministers, the BNB and the National Audit Office to whom it sends its annual reports.

34. **Households and small and medium enterprises that have deposits in the banking system will also benefit from the project.** The BDIF protects depositors up to an insured limit of € 100,000 (BGN 196,000), which is the mandatory deposit insurance limit in all EU Member States. Enhancing the financial and institutional capacity of the BDIF will ensure that these banking customers will be able to receive a prompt compensation in the case of a bank failure.

35. **Finally, Bulgaria's banking system and economy as a whole will benefit from the Project.** Solid financial footing for BDIF will have a positive impact on maintaining confidence of depositors and make the banking system more resilient to possible shocks. This will ensure a steady increase in the amount of domestic savings that can be mobilized for more productive uses, which, in turn, can lead to increased growth and job creation. Banks that operate in Bulgaria will also benefit from the increased ability of the BDIF to meet its deposit insurance and resolution obligations, as it minimizes the chances of a small banking failure from becoming a system-wide issue that would negatively impact the operations of all banks. This is particularly important in the light of the ongoing AQR exercise which will provide an independent assessment of the health of Bulgarian banks.

PDO Level Results Indicators

36. **The project is expected to lead to improvements in the financial and institutional capacity of the BDIF, with results expected in two areas:**

a) BDIF reserves reach the equivalent of 1.5 percent of covered deposits, in the absence of bank failures[9];

b) BDIF performing its legally mandated technical functions[10], including in any future bank failures in which its resources are utilized.

37. **These PDO level results indicators are underpinned by a series of disbursement linked indicators (DLIs) that will be utilized to achieve these results.** Annex 2 presents the DLIs and the targets for disbursement.

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[9] This figure is consistent with the BDIF's target funding ratio of 1 percent of covered deposits specified in the new deposit insurance law, and is higher than the present minimum funding ratio stipulated by the relevant EU directive (0.8 percent).

[10] BDIF's legally mandated technical functions that are directly related to the project's performance are: collection of premiums from banks, overseeing bankruptcy administration of insolvent banks, payout of insured depositors in case of bank failures, and financing the cost of bank resolution up to a ceiling prescribed in the law.

III. PROJECT DESCRIPTION

A. Project Components

38. **The Project Development Objective will be accomplished through:**

(a) Financing the BDIF's deposit insurance fund with sufficient resources (from WB and other external creditors, bank premiums, recoveries, and investments) to allow it to meet deposit insurance and bank resolution obligations; and

(b) Enhancing the BDIF's institutional capacity to fulfill its mandate.

39. **The Project will have a single component, with the World Bank financing to be used solely to build up the BDIF's reserves held in the deposit insurance fund.** Pursuant to OP/BP 10.00, such expenditure meets the productive use requirements as financing of a deposit insurance scheme helps increase confidence in the financial system. This, in turn, is likely to lead to increased deposits in the banking sector, which can be utilized for financing investment lending and other forms of productive economic activity. The Bank has financed Deposit Insurance Schemes through IPF instruments in the past[11] and the eligibility under OP/BP 10.00 has already been established.

40. **The project will follow the results-based format with WB financing made available to the BDIF in several tranches based on the achievement of the following Disbursement Linked Indicators (DLIs):**

a) DLI 1. Increase the BDIF reserves through premium collection from banks.

- DLI 1.1 - Regulation on collecting risk-based premium contributions from banks has been issued.
- DLI 1.2 - Premiums for 2016 are collected by BDIF from banks by May 31, 2016, in the amount set forth in Schedule 4 to the Project's Loan Agreement.
- DLI 1.3 - Premiums for 2017 are collected by BDIF from banks by May 31, 2017, in the amount set forth in Schedule 4 to the Project's Loan Agreement.

b) DLI 2. Make progress in asset recovery process from bankrupt banks.

- DLI 2.1 - BDIF recovers from bankrupt banks and transfers into BDIF's account with BNB the amount set forth in Schedule 4 to the Project's Loan Agreement.
- DLI 2.2 - BDIF recovers from bankrupt banks and transfers into BDIF's account with BNB the amount set forth in Schedule 4 to the Project's Loan Agreement.

c) DLI 3. Strengthen BDIF's funding structure.

[11] Most recently, in Serbia Deposit Insurance Strengthening Project (P146248), approved in FY14.

- DLI 3.1 - BDIF has entered into an agreement to secure a loan or a backstop liquidity facility, from a creditor other than the World Bank, in the amount of at least €300 million, to be in place until December 31, 2021, and said agreement has become effective by September 30, 2016.

d) DLI 4. Improve BDIF's ability to anticipate and respond to problems in the banking sector.

- DLI 4.1 - BDIF and BNB have signed an updated Memorandum of Understanding (MoU) regulating, inter alia, the flow of information between the two entities.
- DLI 4.2 - Summary of results of independent Asset Quality Review of commercial banks has been shared with BDIF by October 31, 2016.

e) DLI 5. Improve BDIF's ability to undertake depositor payout and bank resolution functions.

- DLI 5.1 - Public awareness survey conducted and public awareness strategy has been approved by BDIF Board.
- DLI 5.2 - Contingency plan for BDIF's actions in the case of deposit payout or bank resolution event, based on the BDIF's mandate under the current legal framework, has been adopted by BDIF Board.

41. **DLIs 1, 2 and 3 seek to accomplish the objective of improving the financial capacity of the BDIF, contributing to the goal of building the BDIF reserves to the equivalent of 1 percent of covered deposits.** Following the KTB payout, it is critically important that the BDIF's reserves are restored as soon as possible to a level that provides credible protection against possible future bank failures. To improve its long-term financial standing, ideally the BDIF should also repay the relatively costly loan from the Ministry of Finance as soon as possible. In addition to the financing expected under the proposed WB project, this will be achieved by: (i) collecting annual premiums from commercial banks; (ii) collecting proceeds from disposal of assets of bankrupt banks; and (iii) mobilizing additional financing from external borrowers.

42. **Accordingly, the first set of DLIs is based on the timely collection of annual risk-based contributions from commercial banks.** This will require the adoption of methodology for risk-based contributions from member banks as foreseen in the new Law on Bank Deposit Guarantee which is in turn based on the EU DGSD. The new Law also empowers the BDIF's Management Board to set the amount of total annual premium to be collected from banks, taking into account, among other factors, the banking system profitability and the need for banks to start simultaneously contributing to the newly established Resolution Fund.

43. **The second set of DLIs seeks to record the expected recoveries from the KTB bankruptcy estate which will further contribute to building up the BDIF's reserves.** BDIF has been subrogated to the amount of covered deposits reimbursed to depositors of KTB and filed these claims with the bankruptcy administrator.

44. **DLI 3 seeks to ensure that the BDIF mobilizes additional long-term funding from other external creditors.** It is estimated that in order to achieve a more prudent funding ratio from 2016 onwards, the BDIF would need to raise additional funding from the external creditors in the amount similar to the WB loan. The BDIF is currently in advanced discussions with EBRD regarding a possible loan in the amount of €300 million from this institution.

45. **DLIs 4 and 5 seek to accomplish the objective of enhancing the institutional capacity of the BDIF.** As stated in section VI.B below, Bulgaria already has a relatively well developed legal and institutional framework for deposit insurance, in particular following the recent transposition of relevant EU Directives into national law. Accordingly, the few actions envisioned in this area draw on the lessons from the KTB failure and the recommendations from the recent IADI assessment, and are consistent with the authorities' plans for implementation of the new Law on Bank Deposit Guarantee and the Law on the Recovery and Resolution of Credit Institutions and Investment Firms.

46. **The fourth set of DLIs will support improvements in the BDIF's ability to anticipate and respond to problems in banking sector through receiving relevant information from BNB in the timely manner**. Specifically, the new MoU between BNB and BDIF will expand the scope of the bank-specific information to be shared between the two institutions on a regular basis. In addition, the BNB is committed to share with the BDIF the summary of bank-specific results from the upcoming Asset Quality Review of commercial banks, so that the BDIF is fully prepared to deal with potential problem banks within its current legal mandate.

47. **Finally, the fifth set of DLIs seeks to improve the ability of BDIF to perform its legally mandated functions in the case of bank failure.** Specifically, DLI 5.1 calls for the BDIF to conduct a nationwide public awareness survey, and based on its results, adopt a public awareness strategy. DLI 5.2 seeks to ensure that the BDIF updates its contingency planning to reflect the new legal framework that governs BDIF's responsibilities during the shortened depositor payout and the newly established bank resolution process.

B. Project Financing

48. **Details of the project cost and financing are provided in the table below.** IBRD financing is not subject to government tax.

Project Cost and Financing

Project Components	Project cost	IBRD or IDA Financing	% Financing
1. Improving the financial and institutional capacity of the BDIF	EUR 300 million	EUR 300 million	100%
Total Project Costs	EUR 300 million	EUR 300 million	100%
Front-End Fees	EUR 0.75 million[12]		
Total Financing Required	EUR 300 million	EUR 300 million	100%

C. Series of Project Objective and Phases *(If Applicable)*

N/A

D. Lessons Learned and Reflected in the Project Design

49. **Past WB projects in financial sector have shown that having both solid legal framework and well-resourced implementation bodies is critical for a stable and efficient banking system.** In this regard, the proposed Project is based on the solid legal framework for deposit insurance and bank resolution consistent with EU requirements. As part of project preparation discussions, the team shared with the authorities a number of comments on the draft deposit insurance legislation, which have been largely taken into account in the final legislation enacted in mid-2015. Since Bulgaria has by now put in place a solid legal framework, the focus of this operation will be on strengthening the BDIF's financial and institutional capacity to be able to perform its functions in accordance with its current legal mandate. A Results-Based IPF is considered to be the optimal instrument to achieve this goal, as by design it focuses more on achieving and sustaining actual results rather than legal or policy changes.

50. **The project also reflects the lessons from previous Bank projects aimed at strengthening deposit insurance schemes.** In the most recent and relevant case of Serbia (Board approval in 2014), the instrument used was a results-based IPF of USD 200 million, with specific actions designed in order to strengthen the financial and institutional capacity of Serbia's Deposit Insurance Agency over the course of 2.5 years. Although the Serbian project had a somewhat different design[13], it put emphasis on having the adequate legal framework in place as a pre-condition for WB financing, conducting a robust diagnostic of deposit insurance framework against international best practice at the preparation stage, and having a set of clearly formulated DLIs that seek to record improvements in both the financial and institutional capacity of deposit insurance scheme, a precedent followed in the proposed project.

[12] To be paid with the Borrower's own resources.
[13] The Borrower was the MoF, which passed on the WB loan proceeds to the deposit insurance fund.

IV. IMPLEMENTATION

A. Institutional and Implementation Arrangements

51. **The BDIF will serve as the Borrower and implementing agency, while the MOF will serve as a representative of the Republic of Bulgaria, which will provide a sovereign guarantee for the WB loan.** The implementation arrangements are expected to be fairly straightforward as the WB funds will not be used for procurement of goods or services, and there will be a limited number of disbursements against DLIs. The BDIF does not have prior experience in implementing WB projects, and will need to designate a small team of relevant staff, led by a Project Coordinator, to ensure the Project is properly implemented. The principal activities of the implementing agency will comprise: (i) verifying DLIs achievement in accordance with protocols agreed with the Bank; (ii) reporting on the Bank transfers that result in the financing of the BDIF; and (iii) liaising with and reporting to the Bulgarian authorities and the World Bank on project progress.

52. **The Borrower will be asked to ensure that throughout the project implementation period it maintains adequate governance and financial management arrangements** to reflect the operations, resources and expenditures of the implementing agency, which are acceptable to the World Bank.

53. **The Bulgarian National Bank and the Ministry of Finance will be important stakeholders.** Both of these entities, in addition to the BDIF, play a critical role in the financial safety net, and BNB and the Government of Bulgaria are represented on the BDIF's management board. Therefore, the project design and implementation will require buy-in and close cooperation from both parties in order to ensure that the Project Development Objective is achieved.

B. Results Monitoring and Evaluation

54. **The main outcome indicators for the project and the principal results (listed in Annex 1), and DLIs (listed in Annex 2), will serve as the basis for results monitoring and evaluation.** The BDIF will be responsible for collecting the data required for monitoring and evaluation and for verification of the DLIs based on protocols outlined in Annex 3. Indicators will be measured against agreed targets and compared to defined baselines. Project progress reports will be prepared by the BDIF on a semi-annual basis. These reports will include BDIF's interim unaudited financial statements.

C. Sustainability

55. **The sustainability of the BDIF will be strengthened through the design of the project.** The project has been designed as a Results-Based IPF in order to improve the sustainability of the BDIF. The project not only finances the BDIF, but also enhances its institutional capacity through the achievement of the relevant DLIs.

V. **KEY RISKS**

A. Overall Risk Rating and Explanation of Key Risks

56. **The main <u>policy</u> risk relates to the ability and willingness of authorities to implement a broader set of banking sector reform measures, drawing on the lessons from the failure of KTB.** In addition to strengthening the BDIF's financial and institutional capacity, the stability of Bulgaria's banking system depends on continued progress in other technically complex and politically sensitive reform areas, including banking supervision, bank resolution framework, and corporate governance/risk management of banks, including domestically owned ones. As a mitigating factor, there is a widely shared agreement between the authorities and key development partners (EC, WBG, IMF, EBRD) on the importance of this agenda. It is expected that the WBG, along with other development partners, will remain actively engaged, through policy dialogue (including upcoming FSAP) and technical assistance, in implementing the broader financial sector reforms outlined above in Section I.C.iii. In particular, given that the BDIF has requested a World Bank loan as well as a loan from the EBRD in parallel, the World Bank and the EBRD have closely collaborated to ensure alignment of objectives and full complementarity of both operations.

57. **The risks related to the design of the project, the delivery monitoring, and risks related to the implementing agency are low.** The achievement of the PDO is dependent on the DLIs being met. Considering that disbursements are contingent on achievement of DLIs, the design of the project is considered to be low risk. The delivery monitoring risks is also low as there are a small number of DLIs that will need to be monitored, and the monitoring will be done by the same entity (BDIF) that is responsible for achievement of majority of DLIs. While several DLIs are dependent on actions by the third parties, particularly BNB, they are fully consistent with the current legal framework and BNB's policy statements. Finally, although BDIF did not have prior experience of implementing WB projects, it is a well-established entity with adequate capacity in terms of staffing, IT systems, etc.

58. **The risk of major changes in the legal framework will be mitigated through a specific legal covenant.** Specifically, the loan agreement will allow for the project to be suspended if the legislation related to the deposit insurance framework has been amended, suspended, abrogated, repealed or waived so as to affect materially and adversely the BDIF's ability to perform its deposit insurance and bank resolution obligations. An additional mitigating factor is that the national legislation needs to be generally compliant with relevant EU regulations.

59. **Based on the above analysis, the overall risk for this operation is considered *moderate*.**

VI. APPRAISAL SUMMARY

A. Economic and Financial (if applicable) Analysis

60. **The successful implementation of this project would lead to significant economic benefits for Bulgaria.** Ensuring that the BDIF is able to effectively function as part of the financial safety net helps maintain confidence in the banking system, especially important in view of lingering regional and domestic risks. This confidence will stimulate uninterrupted growth in domestic savings channeled through the banking system that can then be allocated to productive purposes. These resources can then be utilized for investments that, among other things, lead to job creation and shared prosperity. In the event of a bank failure, the project will help ensure that insured depositors, the overwhelming majority of whom are households, will have prompt access to their savings as prescribed by law.

B. Technical

61. **The design of the project has been based on the recent assessment of Bulgaria's deposit insurance system against internationally accepted Core Principles for Effective Deposit Insurance Systems.** The assessment of the current state of the implementation of the BCBS-IADI Core Principles (CP) for Effective Deposit Insurance Systems in Bulgaria has been conducted in April 2015 at the request of the Bulgarian authorities. While the assessment found that Bulgaria has a relatively well developed legal and institutional framework for deposit insurance, it also revealed a number of areas where improvements are necessary:

(a) Funding (CP 11): "A deposit insurance system should have available all funding mechanisms necessary to ensure the prompt reimbursement of depositors' claims including a means of obtaining supplementary back-up funding for liquidity purposes when required. Primary responsibility for paying the cost of deposit insurance should be borne by banks since they and their clients directly benefit from having an effective deposit insurance system. For deposit insurance systems (whether ex-ante, ex-post or hybrid) utilizing risk-adjusted differential premium systems, the criteria used in the risk-adjusted differential premium system should be transparent to all participants. As well, all necessary resources should be in place to administer the risk-adjusted differential premium system appropriately."

(i) *Result of the assessment:* The deposit insurance fund has been almost depleted following the KTB payout. The assessment recommends that authorities should aim for expedited replenishment of deposit insurance fund taking into account country specific as well as regional risk factors, and BDIF's role in providing deposit insurance and carrying out certain bank resolution obligations. The assessment also recommends to introduce risk-based premiums.

(ii) *Impact on the design of the project:* In addition to the direct financing being provided by the WB loan, a number of DLIs focus on ensuring the BDIF receives sufficient funding from various sources to reach and exceed the target funding ratio of 1 percent of covered deposits by the end of project implementation period. One of the DLIs also foresees that riskier banks will need to bear a higher responsibility for financing the BDIF (by introducing risk-based premiums).

(b) Relationships with other safety-net participants (CP 6): “A framework should be in place for the close coordination and information sharing, on a routine basis as well as in relation to particular banks, among the deposit insurer and other financial system safety-net participants. Such information should be accurate and timely (subject to confidentiality when required). Information-sharing and coordination arrangements should be formalized.”

(i) *Result of the assessment:* System-wide coordination and information exchange between BDIF and other financial safety net players need strengthening. The MoU between BNB and BDIF, which covers the most important information exchange for BDIF, needs to be updated.

(ii) *Impact on the design of the project:* Two of the DLIs aim at improving information sharing to ensure that the BDIF receive sufficient and timely information on risks in the banking system.

(c) Early detection and timely intervention and resolution (CP 15): “The deposit insurer should be part of a framework within the financial system safety net that provides for the early detection and timely intervention and resolution of troubled banks. The determination and recognition of when a bank is or is expected to be in serious financial difficulty should be made early and on the basis of well-defined criteria by safety-net participants with the operational independence and power to act.”

(i) *Result of the assessment:* The failure of KTB demonstrated that the framework in place at the time was not sufficient and not in line with international best practices.

(ii) *Impact on the design of the project:* The recent enactment of the Law on the Recovery and Resolution of Credit Institutions and Investment Firms, which transposes the EU BRRD into Bulgarian law, is addressing these shortcomings. In addition, one of the DLIs aims at improving BDIF’s ability to undertake depositor payout and bank resolution functions, through the adoption of a comprehensive contingency plan.

(d) Recoveries (CP 18): “The deposit insurer should share in the proceeds of recoveries from the estate of the failed bank. The management of the assets of the failed bank and the recovery process (by the deposit insurer or other party carrying out this role) should be guided by commercial considerations and their economic merits”.

(i) *Result of the assessment:* The withdrawal of KTB’s banking license was challenged in administrative courts, preventing the opening of formal bankruptcy proceedings, as its conditions (formal withdrawal of the license) were not met. This left BDIF in a situation under which it started paying out deposits with the withdrawal of the license but could not receive any recoveries from the estate.

(ii) *Impact on the design of the project:* The latest amendments to the Law on Credit Institutions addressed these shortcomings for future bank failures. In addition, with the transposition of the EU BRRD into national law, the BDIF's will have the status of a priority creditor, improving the recovery rate in future bank bankruptcies. Finally, some of the DLIs focus on ensuring progress in the recovery process from the KTB estate.

(e) Public awareness (CP 12): "In order for a deposit insurance system to be effective it is essential that the public be informed on an ongoing basis about the benefits and limitations of the deposit insurance system"

(i) *Result of the assessment:* Although the BDIF's Management Board has adopted a Communication Policy, it does not include a long-term strategy with specific milestones (e.g. to increase levels of awareness above a certain percentage) to be achieved, and extent of current public awareness has not been assessed.

(ii) *Impact on the design of the project:* One of the DLIs aims at introducing specific milestones such as the completion of a public awareness survey and the adoption of a long term public awareness strategy based on survey results.

C. Financial Management

62. **A financial management (FM) assessment has been carried out by the Bank team to review BDIF`s financial performance, operational capacity and governance framework to determine if the entity has satisfactory arrangements in place to implement the proposed operation.** As the financing mechanism is straightforward with relatively few tranches envisaged based on DLIs' achievement, and given the current capacity of the BDIF to ensure controls over the management and monitoring of the project, the residual FM risk of the project is assessed as "moderate". The assessment concluded that the FM arrangements are acceptable. The main outcomes of the assessment, with additional details reflected in Annex 3, are summarized below.

63. ***Implementation arrangements***. The proposed operation will, to the extent possible, rely on the existing organizational and management structures of BDIF, including the existing system of internal controls, accounting and financial reporting.

64. ***Disbursement arrangements.*** Project funding will be based on the achievement of DLIs as certified through verification protocols described in Table 7 in Annex 3. Project funds will flow from the World Bank – either as an *advance*, via a Designated Account (DA) to be opened in the BNB, or by *direct payment* to the BDIF's foreign account, as DLIs are met. Loan funds will be channeled to a Designated Account (DA) to be opened in the IBRD Loan currency in the BNB for project purposes. Transfers from the IBRD Loan will be initiated by submission of

withdrawal applications supported with documentation specified in the Disbursement Letter. Funds received into the DA will be transferred to BDIF's foreign currency account. Statements of Expenditures (SOEs) in the form and content outlined in the Disbursement Letter will be utilized to document eligible expenditures under the project when advance method is used An alternative disbursement mechanism will be direct payments from the Loan Account into the BDIFs foreign currency account on the basis of certified documentation evidencing achievement of DLIs.

65. ***Loan advance.*** The BDIF may withdraw an amount not to exceed the equivalent of €100 million as an advance. However, if in the assessment of the Bank, the DLIs are subsequently not achieved (or only partially achieved) up to the amount of advance, the Borrower will be required to refund the gap between the advance amount and the total sum of the amounts associated with achieved DLIs.

66. ***Interim financial reporting.*** Interim financial reports (IFRs) will be prepared by the BDIF on a semi-annual basis and submitted to the Bank for review, as part of regular overall project reports described in section IV.B of this document. The IFRs should present information on the IBRD Loan transfers received during the reporting period and cumulatively, and on the future transfers expected over the next twelve months based on the progress with achieving DLIs. The IFRs would also include the interim (unaudited) statement of BDIF's financial position for the respective six months period, reflecting separately the IBRD Loan transfers. The timeline for submission of IFRs to the Bank will be within 45 days after the end of each reporting period.

67. ***Verification of DLIs***. The achievement of DLIs will be certified by the BDIF and verified by the Bank technical team based on the information and documents provided by the Borrower in accordance with agreed verification protocols. Withdrawal applications may be prepared at any time after DLIs are achieved and verified, with amounts received reflected in progress reports covering that period. In addition, auditors acceptable to the Bank will conduct ex-post review of achievement of DLIs as part of the scope of the annual entity audit, extended in line with terms of reference satisfactory to the Bank, as detailed in Annex 3. The Bank reserves the right to require ex-ante verification by the independent auditor of the DLIs' achievement at any point throughout project implementation.

68. ***Audited annual financial statements.*** BDIF's existing annual financial reporting and auditing arrangements are considered acceptable to the Bank. BDIF will be required to continue the practice of having its annual financial statements prepared in accordance with International Financial Reporting Standards and audited in accordance with International Standards on Auditing. In the event that in any given calendar year the BDIF's assets become less than the sum of the Bank transfers to the BDIF, the auditors shall confirm in the scope of the entity audit that funds in an amount at least equivalent to the difference between the sum of the IBRD Loan transfers to BDIF and BDIF's assets have been used solely for the purposes of paying compensation on account of its deposit insurance and bank resolution obligations in accordance with the applicable laws and regulations, not including repayment of funds borrowed for the

above purposes from entities other than the MoF, or that the difference is due to BDIF's investment policy in line with the legislation. The audited financial statements together with the management letter will be submitted to the Bank within six months following the end of each financial year. As required by the Bank's Access to Information policy, audited financial statements will be publicly disclosed both by BDIF and the Bank.

D. Procurement

69. **The project does not trigger any World Bank procurement policies.** The proceeds from the project will not be used for procurement of goods or services.

E. Social (including Safeguards)

70. **The project does not trigger any World Bank social safeguards policies.** The nature of the project does not lend itself for social impacts.

F. Environment (including Safeguards)

71. **The project does not trigger any World Bank environmental safeguards policies.** Therefore, the project has been assigned a Category 'C' in accordance with the World Bank safeguard policy OP/BP/GP 4.01.

G. Other Safeguards Policies Triggered *(if required)*

N/A

H. World Bank Grievance Redress

72. Communities and individuals who believe that they are adversely affected by a World Bank (WB) supported project may submit complaints to existing project-level grievance redress mechanisms or the WB's Grievance Redress Service (GRS). The GRS ensures that complaints received are promptly reviewed in order to address project-related concerns. Project affected communities and individuals may submit their complaint to the WB's independent Inspection Panel which determines whether harm occurred, or could occur, as a result of WB non-compliance with its policies and procedures. Complaints may be submitted at any time after concerns have been brought directly to the World Bank's attention, and Bank Management has been given an opportunity to respond. For information on how to submit complaints to the World Bank's corporate Grievance Redress Service (GRS), please visit http://www.worldbank.org/GRS. For information on how to submit complaints to the World Bank Inspection Panel, please visit www.inspectionpanel.org.

Annex 1: Results Framework and Monitoring

BULGARIA: Deposit Insurance Strengthening Project

Project Development Objectives

PDO Statement

The Project Development Objective is to strengthen the financial and institutional capacity of the Bulgarian Deposit Insurance Fund (BDIF) so as to enable it to meet its deposit insurance and bank resolution obligations.

These results are at	Project Level

Project Development Objective Indicators

Indicator Name	Core	Unit of Measure	Baseline (Dec. 31, 2015)	Cumulative Target Values[14] YR1 (Dec. 31, 2016)	YR2 (Dec. 31, 2017)	End Target (Dec. 31, 2018)	Frequency	Data Source/ Methodology	Responsibility for Data Collection
BDIF reserves reach the equivalent of 1.5 percent of covered deposits, in the absence of bank failures[15]	☐	%	0.75%	*	*	*	Annual	Project reports	BDIF

[14] Target values marked with * are defined in the Project Operations Manual.

[15] The proposed target ratio is based on BDIF's cash flow projections under a conservative scenario. The projected ratio of reserves to covered deposits reflects the BDIF's plans to accumulate reserves in order to repay its loans and reach/maintain the legally mandated minimum 1% level by 2024 (including potential payouts in the meantime).

BDIF performing its legally mandated technical functions, including in any future bank failures in which its resources are utilized		Yes/No	No[16]	Yes	Yes	Yes	Annual	Project reports	BDIF

Intermediate Results Indicators

Indicator Name	Core	Unit of Measure	Baseline (Dec. 31, 2015)	Cumulative Target Values[17]			Frequency	Data Source/ Methodology	Responsibility for Data Collection
				YR1 (Dec. 31, 2016)	YR2 (Dec. 31, 2017)	End Target (Dec. 31, 2018)			
Risk-based premium collection		Yes/No	No	Yes	Yes	Yes	Annual	Verification Protocol for DLI 1.1	BDIF
Premium collected from banks		Amount (BGN)	0[18]	*	*	*	Annual	Verification Protocol for DLI 1.2 and 1.3	BDIF
Recoveries from bankrupt banks		Amount (BGN)	0[19]	*	*	*	Annual	Verification Protocol for DLI 2.1 and 2.2	BDIF
Long-term loan or back-stop funding facility mobilized by BDIF[20]		Amount (EUR)	0	300 mln	300 mln	300 mln	Annual	Verification Protocol for DLI 3.1	BDIF

[16] This indicator refers to the BDIF performing fully the legally mandated technical functions stipulated under the newly enacted LBDG. Since the BDIF is currently in the process of preparing for implementation of the new law, the baseline value for end 2015 is set at No.
[17] Target values marked with * are defined in the Project Operations Manual.
[18] This indicator refers to premium collection in years 2016, 2017, and 2018; hence the baseline value is 0.
[19] This indicator refers to recoveries collected in years 2016, 2017, and 2018; hence the baseline value is 0.
[20] In addition to the World Bank loan provided under this Project, and current loan from the Government, which is expected to be mostly repaid by end 2017.

Updated BNB-BDIF MOU in place	☐	Yes/No	No	Yes	Yes	Yes	Annual	Verification Protocol for DLI 4.1	BDIF
Results of Asset Quality Review shared with BDIF	☐	Yes/No	No	Yes	Yes	Yes	Annual	Verification Protocol for DLI 4.2	BDIF
Public awareness strategy in place	☐	Yes/No	No	No	Yes	Yes	Annual	Verification Protocol for DLI 5.1	BDIF
BDIF Contingency Plan in place	☐	Yes/No	No	Yes	Yes	Yes	Annual	Verification Protocol for DLI 5.2	BDIF

Project Development Objective Indicators

Indicator Name	Description (indicator definition etc.)
BDIF reserves reach the equivalent of 1.5 percent of covered deposits, in the absence of bank failures	This indicator is a measure of the achievement of the target fund size for the BDIF based on the team's analysis of BDIF's projected cash flow, in the absence of new payouts. It assumes a covered deposit level of BGN 44.8 billion, which is the expected level as of December 31, 2015. It also assumes the repayment of a substantial portion of the Government loan to BDIF (BGN 1.68 bn) by end 2017.
BDIF performing its legally mandated technical functions, including in any future bank failures in which its resources are utilized	This is a measure of the BDIF having the capacity to perform the technical functions that are defined in Bulgaria's new legal framework for deposit insurance and bank resolution, both in the normal circumstances and in the case of a bank failure in which BDIF resources are utilized. BDIF's legally mandated technical functions that are directly related to the project's performance include: collection of premiums from banks, overseeing bankruptcy administration of insolvent banks, and, if needed, payout of insured depositors in case of bank failures, and financing the cost of bank resolution up to a ceiling prescribed in the law.

Intermediate Results Indicators

Indicator Name	Description (indicator definition etc.)
Risk-based premium collection	BDIF implements the new methodology for risk-based premium collection consistent with the EU rules (DLI 1.1)

Premium collected from banks	BDIF collects annual premium from commercial banks (DLI 1.2 and 1.3)
Recoveries from bankrupt banks	BDIF receives inflows from the bankruptcy estate of KTB, as one of the biggest creditors due to the payout of insured deposits (DLI 2.1 and 2.2)
Long-term loan or back-stop funding facility mobilized by BDIF[21]	BDIF fills its funding gap by mobilizing a long-term loan or back-stop funding facility from another IFI or private creditors (DLI 3.1)
Updated BNB-BDIF MOU in place	The new MOU will enable BDIF to receive the necessary information about risks in the banking system (DLI 4.1)
Results of Asset Quality Review shared with BDIF	Providing the BDIF with the necessary information on problematic banks from the in-depth independent assessment of all commercial banks in Bulgaria (DLI 4.2)
Public awareness strategy in place	Based on the results of public awareness survey, BDIF approves the public awareness strategy (DLI 5.1)
BDIF Contingency Plan in place	BDIF approves a comprehensive contingency plan to make it better prepared to exercise its mandate in the event of bank failure (DLI 5.2)

[21] In addition to the World Bank loan provided under this Project, and current loan from the Government, which is expected to be mostly repaid by end 2017.

Annex 2: Detailed Project Description

BULGARIA: Deposit Insurance Strengthening Project

A. Background on the Bulgarian Deposit Insurance Fund (BDIF)

1. **The Bulgarian Deposit Insurance Fund (BDIF) is an independent public institution established in January 1999 under the Law on Bank Deposit Guarantee.** The Fund protects deposits of natural persons and legal entities with member banks and reimburses depositors for the insured deposit amount of BGN 196,000 (€ 100,000) in the event of a member bank failure. With this level, BDIF insures 99.72 percent of depositors and 75.1 percent of deposits fully. Deposits in Bulgaria are small compared to the level of coverage, as 71.33 percent of deposit accounts are smaller than BGN 1,000. The BDIF can either payout the insured deposits of a bank in bankruptcy or finance the transfer of insured deposits under the newly enacted bank resolution law. Under the Law on Bank Bankruptcy, the BDIF administers bank bankruptcy proceedings in view of securing fair satisfaction of creditors and ensuring transparency of proceedings. The BDIF has currently 23 member banks.[22]

2. **The BDIF comprises 19 employees and appears to be adequately staffed.** BDIF is organized into the following departments: (i) Treasury; (ii) Deposit Guarantee and Bank Bankruptcy; (iii) Risk Assessment and Analysis; (iv) Corporate Communications and International Cooperation; (v) Legal; (vi) Finance and Accounting; and (vii) Human Resources and Administration. Less than 1 percent of BDIF's budget (2014) is spent on training and development of its staff. BDIF spends 6.79 percent of its annual budget (2014) on information technology.

3. **BDIF has a one-tier system of governance in form of a five member Management Board.** BDIF's Chairman is responsible for the day-to-day management of the deposit insurer. The Chairman is designated by the Council of Ministers, while his Deputy is nominated by the BNB. One member is nominated by the Association of Banks in Bulgaria (but cannot be an active banker). Two more members are jointly nominated by the Chairman and his Deputy.

4. **The BDIF has the following powers**: (i) assessing and collecting premiums; (ii) reimbursing insured depositors through agent banks; (iii) obtaining depositor records directly from banks, (iv) sharing information within the safety-net; (v) compelling member banks to comply with their membership obligations via the BNB; (vi) setting operating budgets, policies and practices; and (vii) entering into contracts.

5. **As Bulgaria is a Member State of the European Union, the deposit insurance framework is largely based on EU legislation from which Bulgaria cannot deviate.** Bulgaria has transposed all three EU Directives on Deposit Guarantee Schemes (DGSD) into national law. The latest EU directive from 2014 was implemented in August 2015. In particular, the DGSD envisages the payment of insured deposits within seven business days after a bank's license was

[22] Branches of EU banks operating in Bulgaria are covered by home countries' deposit guarantee schemes.

revoked or a competent authority declares the unavailability of deposits and that the target level of the deposit fund should be at a minimum of 0.8 percent of covered deposits. Bulgaria has decided to adopt a target level of 1 percent of covered deposits for its deposit insurance fund which is 25 percent higher than the EU minimum level.

6. **The BDIF is maintaining a deposit insurance fund which is ex-ante funded by its member banks.** The sources of the fund are: (i) annual premiums from banks; (ii) extraordinary premiums from banks; (iii) investment returns; (iv) recoveries from the estate of failed banks after the subrogation of depositor claims; and (v) other sources such as loans, donations, foreign assistance, etc. The BDIF is exempt from paying state or local taxes and fees for its deposit guarantee operations, which includes the income of the fund. Emergency funding arrangements exist and are formalized in law, as, by decision of the Management Board, the shortfall might be covered by: (i) requiring from member banks to pay extraordinary premium contributions; and (ii) using loans, including by means of issuance of debt securities and from the budget after a decision by the Council of Ministers. Loans drawn by the fund can be secured by a guarantee issued by the government, or by the fund's assets, including future claims on banks for annual premium.

7. **The Management Board of BDIF is responsible for the sound investment and management of the deposit insurance fund with the requirements for safety and liquidity.** The BNB is by law the depository of the fund's reserves. The funds are invested in: (i) highly liquid debt securities and (ii) deposits with BNB. The Management Board has issued an Investment Policy Statement and a Procedure for Investment Risk Management, which regulates the roles of an Investment Committee, the Risk Assessment and Analyses Department and the Treasury Department. The Board also puts forward investment exposition limits based on different risks (market, credit, liquidity risk, risk of unfairly priced transactions). The Investment Committee, which is chaired by the Chairman of BDIF, approves the investment strategy. BDIF's Management Board reviews the investment strategy on a periodical basis (every 3 months) and monitors the structure of financial assets and liabilities. All investment activities are subject to regular reporting and disclosure.

8. **The current arrangements for transparency and governance of BDIF are deemed appropriate.** BDIF is accountable to the Council of Ministers, the BNB and the National Audit Office to whom it sends its annual reports which includes the annual audit. The annual budget and the report on BDIF's performance are presented to the BNB and the National Audit Office. Since 2003, and based on a recommendation of the National Audit Office, BDIF is also performing an internal audit performed during the last years by an external audit firm. BDIF publishes regularly its annual report and other information via its website and mass media.

B. Analysis of BDIF's funding needs

9. **BDIF's had accumulated sizeable reserves over the years, but they have been fully depleted as a result of the failure of KTB.** As of end 2013, BDIF's funds amounted to BGN 1.836 billion (Figure 1). When the BNB revoked KTB's banking license on November 6, 2014, the reimbursement process of the bank's BGN 3.7 billion (€1.9 billion) of insured deposits by the BDIF started. BDIF's own funds as of November 6, 2014 were BGN 2.1 billion (€1.07 billion) and had been entirely funded through banks' premiums. In order to bridge the funding gap, the Government provided the BDIF with a loan of up to BGN 2 billion (€1.02 billion), with a maturity of up to 5.5 years, at a fixed interest rate of 2.95 percent. BDIF also entered into repurchase agreements with several commercial banks using government bonds from BDIF's investment portfolio as collateral.

10. **At end-2014, BDIF's net investment portfolio (bond portfolio net of repurchase agreements, plus a small cash amount) had shrunk to only BGN 213.7 million, exclusive of the long-term liability with the Government amounting to BGN 1.453 billion.** As of September 2015, the outstanding loan to the Government amounts to BGN 1.698 billion, while BDIF's net investment portfolio stand at BGN 339 million, or 0.76 percent of insured deposits.

11. **The rest of this section discusses the adequate level of financing that BDIF needs in order to meet its legally mandated functions in the event of potential future bank failure.** The overarching public policy objective is to have the BDIF's reserves restored as quickly as possible to a level that provides sustainable and credible protection against possible future bank failures. Best international practices indicate that an optimal fund target must ensure that depositors can be reimbursed promptly and balance the potential losses that each deposit insurer is exposed to with the ability of its member banks to fund the system in normal times. It should also be kept in mind that the BDIF needs to repay the relatively costly loan from the Government by April 2020.

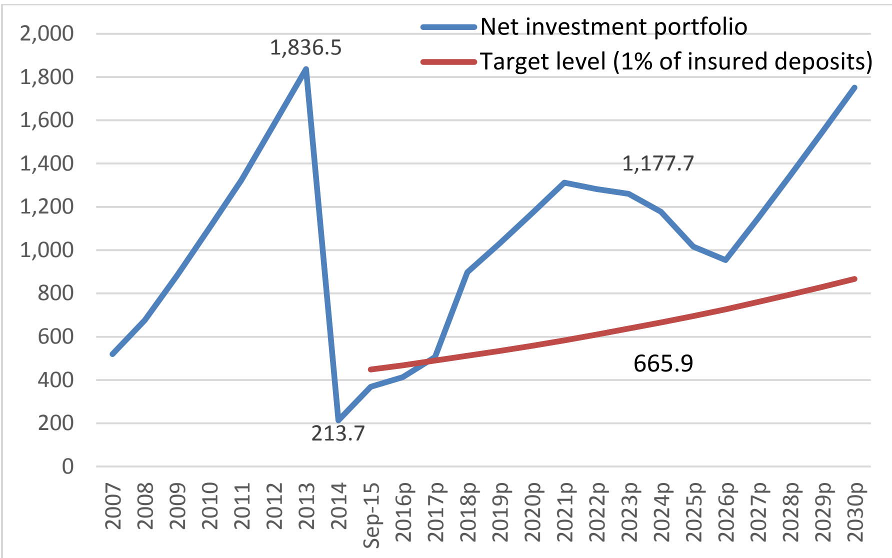
12. **The BDIF strategy envisions the use of three main sources to rebuild its reserves: (i) premiums collected from member banks; (ii) recoveries from estate of bankrupt banks; and (iii) long term loans from international financial institutions.** Firstly, starting in 2016, the Management Board of BDIF will decide every year on an absolute amount to be charged as total annual premiums to its member banks, taking into account –among other things- the profitability of Bulgarian banks and the need for them to start making contributions to the newly established Bank Resolution Fund. In addition, recoveries from the KTB bankruptcy estate are expected to take place starting in 2016, and continue for around three years, with BDIF being one of the largest creditors.

13. **Finally, the World Bank loan together with the parallel EBRD loan are expected to provide long-term financing at a relatively favorable rate.** The combined loans from the World Bank and the EBRD would amount to €600 million, and the costs compare favorably with the terms of current loan from the MOF, or the potential cost of BDIF's borrowing from other creditors.

14. **Based on BDIF's current cash flow projections, the above-mentioned inflows would enable the BDIF to reach its minimum target level by the end of 2017 (Figure 1).** At end-2017, BDIF's net investment portfolio is expected to reach around BGN 505 million. This means that, in the absence of bank failures, and given the BDIF's intention to gradually build reserves to service its financial obligations, the minimum target ratio of 1 percent of covered deposits will be reached much earlier that the deadline of 2024 set in the national and EU legislation. It is also important to note that the BDIF may decide to repay the bulk of the Government loan by end of 2017, thus optimizing its long-term financial position.

15. **In the longer term, the BDIF will continue to increase its reserves, which are projected to reach around BGN 1.178 billion by year 2024.**

Figure 1. BDIF Net Investment Portfolio, historical and projected (BGN million)



Source: BDIF. Net Investment Portfolio = Assets - Liabilities (repos). Decrease in projected portfolio between 2022 and 2026 correspond to the expected repayment of WB and EBRD loans. Outstanding loan amount from the Government not included as liabilities.

16. **It is important that BDIF will at all times keep a minimum reserve balance in its deposit insurance fund to deal with small bank failures without the need to ask for external back-up financing.** Such a request to the government would send a disturbing signal to depositors and the broader market and negatively affect the confidence in the BDIF, which shall be fostered through the World Bank and EBRD loan. In this regard, the latest BDIF's cash flow projections assume an annual net investment portfolio (cash plus bond portfolio) that surpasses the target level from 2017 onwards.

C. Analysis of BDIF's institutional capacity strengthening priorities

17. **This section outlines key areas that need to be strengthened in order to enhance BDIF's capacity to perform its legally mandated functions.** In April 2015, the BDIF was assessed by the WB against the BCBS - IADI Core Principles for Effective Deposit Insurance Systems, which codify the relevant international best practice. While the assessment found that Bulgaria has a relatively well developed legal and institutional framework for deposit insurance, it also revealed a number of areas where improvements are necessary.

Relationships with other safety-net participants

18. **In the past, the financial safety-net framework in Bulgaria was not providing enough close coordination and information sharing.** The recent crisis around KTB clearly demonstrated the need for close coordination and a common communication strategy during crisis time. A Memorandum of Understanding (MoU) between BNB and BDIF, regulating the flow of information between the two entities dates from 1999, and therefore is outdated, often referring to old articles, which have been changed since its signing.

19. **BDIF is currently not a full member of the Financial Stability Advisory Council (FSAC), but may participate in its meetings only upon invitation.** The FSAC is established under the Financial Supervision Commission Act (FSCA) as an advisory body. The FSAC consists of the Minister of Finance, the Governor of the BNB and the Chairman of the FSC. FSAC has competence for carrying out advisory and coordination functions. The FSAC can address proposals and recommendations to its members with regard to the protection and maintenance of financial stability and the prevention and management of financial crises. The Council also has the responsibility to approve a national action plan in the event of crisis. The FSAC meets quarterly, though more frequently if needed, and is supported by a standing committee.

20. **The MoU between BNB and BDIF from 1999 should be updated in the light of the changing regulatory landscape and the transposition of the EU Directives into national law.** The new Law on Bank Deposit Guarantee foresees enhanced information exchange and early warning mechanisms between BNB and BDIF, which should strengthen the information exchange between the two institutions, and should be formalized with the signing of an updated MoU.

Contingency planning and crisis preparedness

21. **The BDIF needs to update its contingency planning to reflect the new legal framework that includes shorter payout deadlines and additional bank resolution responsibilities.** The BDIF with its limited mandate as a "pay-box plus" is not directly involved in the early detection or timely intervention in troubled banks, and these responsibilities are with the BNB and its Banking Supervision Department. However, the early detection and timely intervention framework will be strengthened with the transposition of the EU BRRD and EU DGSD into national law, and therefore BDIF should put emphasis on effective contingency planning, crisis

management policies and procedures of a deposit insurer to ensure that it is able to respond swiftly to the risk of bank failures under the new legal framework.

Recoveries from bankrupt banks

22. **The withdrawal of KTB's banking license was challenged in administrative court, thus delaying the opening of formal bankruptcy proceedings, as its conditions (formal withdrawal of the license) were not met.** The latest amendments to the Law on Credit Institutions introduced a one-month time limit for the Court to rule on any appeals questioning the legality of license revocation. The Court may not suspend the withdrawal of the license until it comes up with an ultimate ruling on the appeal. This is a critical change, as BDIF starts paying out deposits with the withdrawal of the license but cannot receive any recoveries from the estate as long as the bankruptcy is not starting and assets are liquidated.

23. **With the transposition of the BRRD into national law the BDIF's claims ranking in bankruptcy has improved for futures cases as the directive foresees that insured deposits (and the deposit insurance schemes subrogated to them) rank before uninsured deposits.** The recovery rate of BDIF is therefore likely to improve in future bank bankruptcies, based on the experience from the past bankruptcy cases in 1999 and 2000, when BDIF was treated as a priority creditor and recoveries of 100 percent were achieved.

Public awareness

24. **The BDIF's Management Board has adopted a Communication Policy.** The objectives of the policy (improving depositor awareness of the function and activity of BDIF as the prime goal among others) are in line with the public policy objectives (PPOs) and the mandate of BDIF. The policy identifies certain target groups, main topics, communication channels and activities. Furthermore, the goals and principles of BDIF's communication strategy are specified, including aspects of its long-term strategy. However, the policy does not include a long-term strategy with specific milestones (e.g. to increase levels of awareness above a certain percentage) to be achieved, nor does it identify special budget needs for certain (future) activities.

25. **BDIF is advised to conduct a new nationwide public awareness survey to assess people's understanding of deposit insurance.** Such a survey should be undertaken on a regular basis in the future. Based on the results, BDIF should critically assess its current public awareness program. The long-term strategy should identify milestones (level of public awareness to be achieved) and allocate budget for future public awareness activity needs.

D. Details of Project Design

26. **In addition to the project description provided in the main text, this section gives a detailed description of the disbursement linked indicators.** The choice of DLIs has been based on the areas in need of improvement identified in the assessment of Bulgaria's deposit insurance system against BCBS-IADI Core Principles for Effective Deposit Insurance Systems, and focusing primarily on actions under the sole responsibility of BDIF (the Borrower). At the

same time, given the nature of the financial safety net in Bulgaria and the legal status of BDIF, some DLIs of critical importance to strengthening the deposit insurance framework would require action by the BNB (see below for details).

Disbursement Linked Indicator 1. Increase the BDIF reserves through premium collection from banks.

27. **Starting in 2016, the Management Board of BDIF will decide every year an absolute total amount to be charged as annual premiums to its member banks. The new Law on Bank Deposit Guarantee provides for introduction of risk-based contributions as it is foreseen in the EU DGSD.** Article 14 (1) of the Law stipulates that "Not later than by May 1 of the current year, the BDIF shall set the annual premium contribution for each bank, taking into consideration its risk profile and the amount of covered deposits in the bank for the preceding year calculated as an average of the size of covered deposits as of the end of each quarter." The EBA has published guidelines to specify methods for calculating the contributions based on the amount of covered deposits and the degree of risks incurred by the respective member bank, which BDIF will apply as of 2016.

28. **The DLIs associated to premium collection from banks seek to record the achievement of the implementation of actions to be taken by the BDIF in this area, which are in line with the PDO.**

Table 1: DLIs for Premium collection from banks

	2016 Target Date 1 = March 31, 2016	2016 Target Date 2 = May 31, 2016	2017 Target Date = May 31, 2017
DLI #1: Increase the BDIF reserves through premium collection from banks	DLI #1.1: Regulation on collecting risk-based premium contributions from banks has been issued.	DLI #1.2: Premiums for 2016 are collected by BDIF from banks by May 31, 2016, in the amount set forth in Schedule 4 of the Project's Loan Agreement.	DLI #1.3: Premiums for 2017 are collected by BDIF from banks by May 31, 2017, in the amount set forth in Schedule 4 of the Project's Loan Agreement.

Disbursement Linked Indicator 2. Make progress in asset recovery process from bankrupt banks.

29. **Recoveries from the KTB estate are expected to take place starting in 2016, and continue for around three years.** Due to its role in payout to KTB's insured depositors, BDIF is one the bank's largest creditors, and anticipates significant recoveries from the bankruptcy estate.

30. **The DLIs for asset recovery seek to record the expected recovery of assets from the KTB estate.** The DLIs assume a steady recovery process, with inflows distributed more or less

evenly across the three-year recovery period, as foreseen by BDIF's current cash flow projections.

Table 2: DLIs for asset recovery

	2016 Target Date = December 31, 2016	2017 Target Date = December 31, 2017
DLI #2: Make progress in asset recovery process from bankrupt banks	DLI #2.1: BDIF recovers from bankrupt banks and transfers into BDIF's account with BNB the amount set forth in Schedule 4 to the Project's Loan Agreement.	DLI #2.2: BDIF recovers from bankrupt banks and transfers into BDIF's account with BNB the amount set forth in Schedule 4 to the Project's Loan Agreement.

Disbursement Linked Indicator 3. Strengthen BDIF's funding structure.

31. **DLI 3 seeks to ensure that the BDIF mobilizes additional long-term funding from other external creditors in order to rebuild its reserves.** It is estimated that in order to improve the funding ratio from 2016 onwards, the BDIF would need to raise additional funding from the external creditors in the amount similar to the WB loan. The BDIF is currently in advanced discussions with EBRD regarding a possible loan from this institution in the amount of € 300 million.

Table 3: DLIs for strengthening BDIF's funding structure

	2016 Target Date = September 30, 2016	2017 Target Date
DLI #3: Strengthen BDIF's funding structure	DLI #3.1: BDIF has entered into an agreement to secure a loan or a backstop liquidity facility, from a creditor other than the World Bank, in the amount of at least € 300 million, to be in place until December 31, 2021, and said agreement has become effective by by September 30, 2016.	N/A

Disbursement Linked Indicator 4. Improve BDIF's ability to anticipate and respond to problems in the banking sector.

32. **The MoU between BNB and BDIF from 1999 should be updated in the light of the changing regulatory landscape and the transposition of the EU Directives into national law.** The new Law on Bank Deposit Guarantee foresees enhanced information exchange and early warning mechanisms between BNB and BDIF, which should strengthen the information exchange between the two institutions, and should be formalized with the signing of an updated MoU. In addition, the BNB, in its recently published action plan, has committed to sign a coordination and information exchange memorandum with relevant institutions, including BDIF, by December 2015.

33. **Consequently, the first DLI under this area envisions an updated MoU containing provisions for the exchange of, at least, the following information:** (i) financial and regulatory data for determining annual risk based premium for each bank, taking into account the banks' risk profile; (ii) information regarding the issuance of license for banking activities in the Republic of Bulgaria, including a third country bank branch; (iii) notifications in case problems are identified in a bank, which are likely to trigger the deposit guarantee scheme.

34. **The BNB has committed by law to run a review of the quality of assets of the whole banking system.** This asset quality review (AQR) is to be finalized by August 2016, and it will also include stress tests of the whole banking system to assess the capacity of banks to absorb unexpected losses in emergency stress situations. Given that the results of this exercise may result in actions to be performed by BDIF under its legally mandated functions, it is essential that a summary of the AQR is shared with BDIF after it is finalized. In particular, information on identified problems in banks that are likely to trigger the use of the deposit insurance fund should be shared with the required detail for BDIF to prepare adequately for such event. The second DLI in this area seek to ensure that BNB shares with BDIF all necessary information resulting from this exercise that improves the ability of BDIF to respond to a potential use of its reserves.

Table 4: DLIs for improving BDIF's ability to anticipate and respond to problems in the banking sector

	2016 Target Date 1 = June 30, 2016	2016 Target Date 2 = October 31, 2016	2017 Target Date
DLI #4: Improve BDIF's ability to anticipate and respond to problems in banking sector.	DLI #4.1: BDIF and BNB have signed an updated Memorandum of Understanding (MoU) regulating, inter alia, the flow of information between the two entities.	DLI #4.2: Summary of results of independent Asset Quality Review of commercial banks has been shared with BDIF by October 31, 2016.	N/A

Disbursement Linked Indicator 5. Improve BDIF's ability to undertake depositor payout and bank resolution functions.

35. **The first DLI under this area seeks to ensure that BDIF timely conducts a new nationwide public awareness survey to assess people's understanding of deposit insurance.** Based on the results, BDIF should critically assess its current public awareness program. A new long-term strategy should identify milestones (level of public awareness to be achieved) and allocate budget for future public awareness activity needs.

36. **The second DLI under this area seeks to ensure that the BDIF updates its contingency planning to reflect the new legal framework that gives BDIF depositor payout and bank resolution functions.** As the early detection and timely intervention framework will be strengthened with the transposition of the EU BRRD and EU DGSD into national law, BDIF should give emphasis on effective contingency planning, crisis management policies and procedures of a deposit insurer to ensure that it is able to respond swiftly to the risk of bank failures and other events under the new legal framework. The contingency plan would take into account the shortened payout time frame and provide a detailed manual on different actions needed to prepare for the payout of insured deposits, the communication with depositors, the engagement of one or more agent banks and the options to guarantee back-up funding. Furthermore, as the bank resolution law foresees new responsibilities for the BDIF, the contingency plan would foresee how BDIF would implement in a timely manner the transfer of deposits and the set-up of a bridge bank.

Table 5: DLIs for improving BDIF's ability to undertake depositor payout and bank resolution functions

	2016 Target Date = December 31, 2016	2017 Target Date = December 31, 2017
DLI #5: Improve BDIF's ability to undertake depositor payout and bank resolution functions	DLI #5.1: Public awareness survey conducted and public awareness strategy has been approved by BDIF Board.	DLI #5.2: Contingency plan for BDIF's actions in the case of deposit payout or bank resolution event, based on the BDIF's mandate under the current legal framework, has been adopted by BDIF Board

37. **The full set of Disbursement Linked Indicators, with associated loan amounts, is shown in Table 6 below.**

Table 6: Disbursement Linked Indicators for Bulgaria Deposit Insurance Strengthening Project

Disbursement Linked Indicator		***EUR***
DLI #1. Increase the BDIF reserves through premium collection from banks	DLI #1.1: Regulation on collecting risk-based premium contributions from banks has been issued.	DLI #1.1: €30,000,000
	DLI #1.2: Premiums for 2016 are collected by BDIF from banks by May 31, 2016, in the amount set forth in Schedule 4 to the Project's Loan Agreement.	DLI #1.2: (a) €22,500,000 for premiums collected equal to BGN100,000,000, and (b) €150,000 for every additional premiums collected equal to BGN 1,000,000, all up to a maximum of €30,000,000
	DLI #1.3: Premiums for 2017 are collected by BDIF from banks by May 31, 2017, in the amount set forth in Schedule 4 to the Project's Loan Agreement.	DLI #1.3: a) €22,500,000 for premiums collected equal to BGN100,000,000, and (b) €150,000 for every additional premiums collected equal to BGN 1,000,000, all up to a maximum of €30,000,000
DLI #2. Make progress in asset recovery process from bankrupt banks	DLI #2.1: BDIF recovers from bankrupt banks and transfers into BDIF's account with BNB the amount set forth in Schedule 4 to the Project's Loan Agreement.	DLI #2.1: €30,000,000
	DLI #2.2: BDIF recovers from bankrupt banks and transfers into BDIF's account with BNB the amount set	DLI #2.2: €30,000,000

	forth in Schedule 4 to the Project's Loan Agreement.	
DLI #3. Strengthen BDIF's funding structure	DLI #3.1: BDIF has entered into an agreement to secure a loan or a backstop liquidity facility, from a creditor other than the World Bank, in the amount of at least € 300 million, to be in place until December 31, 2021, and said agreement has become effective by September 30, 2016.	DLI #3.1: €30,000,000
DLI #4. Improve BDIF's ability to anticipate and respond to problems in the banking sector	DLI #4.1: BDIF and BNB have signed an updated MOU regulating, inter alia, the flow of information between the two entities. DLI #4.2: Summary of results of independent Asset Quality Review of commercial banks has been shared with BDIF by October 31, 2016.	DLI #4.1: €30,000,000 DLI #4.2: €30,000,000
DLI #5. Improve BDIF's ability to undertake depositor payout and bank resolution functions	DLI #5.1: Public awareness survey conducted and public awareness strategy has been approved by BDIF Board. DLI #5.2: Contingency plan for BDIF's actions in the case of deposit payout or bank resolution event, based on the BDIF's mandate under the current legal framework, has been adopted by BDIF Board.	DLI #5.1: €30,000,000 DLI #5.2: €30,000,000
Total		€300,000,000

Annex 3: Implementation Arrangements

BULGARIA: Deposit Insurance Strengthening Project

Project implementation mechanisms

1. **The BDIF will serve as the Borrower and implementing agency, while the MOF will serve as a representative of the Republic of Bulgaria, which will provide a sovereign guarantee for the WB loan.** The implementation arrangements are expected to be fairly straightforward as the WB funds will not be used for procurement of goods or services, and there will be a limited number of disbursements against DLIs. The BDIF does not have a prior experience with implementing WB projects, and will need to designate a small team of relevant staff, led by a Project Coordinator, to ensure the Project is properly implemented in accordance with WB's fiduciary rules. The principal activities of the implementing agency will comprise: (i) verifying DLIs achievement in accordance with protocols agreed with the Bank; (ii) reporting on the Bank transfers that result in the financing of the BDIF; and (iii) liaising with and reporting to the Bulgarian authorities and the World Bank on project progress.

2. **The Borrower will be asked to ensure that throughout the project implementation period it maintains adequate governance and financial management arrangements** to reflect the operations, resources and expenditures of the implementing agency, which are acceptable to the Bank.

3. **The Bulgarian National Bank and the Ministry of Finance will be important stakeholders.** Both of these entities, in addition to the BDIF, play a critical role in the financial safety net, and BNB and Government of Bulgaria are represented on the BDIF's management board. Therefore, the project design and implementation will require buy-in and close cooperation from both BNB and MOF in order to ensure that the Project Development Objective is achieved.

Financial Management and Disbursement arrangements

4. **The FM capacity of BDIF has been assessed by the Bank team as part of project preparation, with the following results:**

- *Financial Performance*. The underlying objective of the financial analysis of BDIF is to determine its credit-worthiness and financial capacity to manage the Bank financing efficiently. A review of the latest Audited Financial Statements provided by BDIF, for the year ended December 31, 2014, evidences that they were prepared in accordance with International Financial Reporting Standards and received an unmodified audit opinion. The auditors, PricewaterhouseCoopers, also rendered an unmodified opinion on the Annual Activity Report prepared in accordance with the Bulgarian Accounting Act.

- *Business Practices and Operational Capacity*. The purpose of assessment is to evidence that BDIF has adequate and sound policies, administrative structures and business practices to ensure its capacity to operate efficiently, sustainably and transparently. Policies considered included: (i) risk management policies; (ii) investment policies; (iii) premiums collection policy; (iv) business continuity, among others necessary to ensure sound business practices. For this purpose, reliance was placed on the recent assessment of the current state of BDIF's compliance with the BCBS - IADI Core Principles for Effective Deposit Insurance Systems. The assessment observes that, overall, BDIF has demonstrated that it can efficiently fulfill its mandate. Identified areas of improvement are observed as not significantly impacting its ability to undertake project activities and most are being addressed by the proposed operation.

- *Governance***.** The purpose of due diligence work is to confirm that BDIF has adequate managerial autonomy and market oriented governance. A review of existing staffing, management and oversight arrangements evidences sufficient capacity to manage the proposed operation. As part of internal control and oversight arrangements, BDIF has an outsourced internal audit function presently contracted to a local audit firm (AFA). A review of the internal audit work program evidences application of good practice risk-based methodologies.

5. **Disbursement of funds will be based on the achievement and verification of DLIs, under the following procedure:**

- The eligible expenditure is represented by IBRD Loan transfers to capitalize BDIF (i.e., increase its reserves). Statements of Expenditures (SOEs) in the form and content outlined in the Disbursement Letter will be utilized to document eligible expenditures under the project when advance method is used.

- Each DLI is assigned a Euro amount, as detailed in Table 6 in Annex 2, and withdrawals up to the assigned amount of the DLI met will be made based on evidence of the verification of achievement of the DLI, and any other documents as specified in the Disbursement Letter.

- Withdrawals from the Loan Account will be remitted to the foreign currency account (EUR) administered by the BDIF (the Designated Account) within the Bulgarian National Bank (BNB) that will be opened and used solely for proceeds from the Loan account. The deposits will then be transferred to the BDIF's foreign currency account, exclusively for the purposes of financing the Fund, within ten (10) days after the advance from the Bank to the Designated Account.

- Each financing of the BDIF will be confirmed to the Bank as per the frequency and procedures agreed in the Disbursement Letter, through delivery of appropriate documentation evidencing the financing of BDIF. An alternative disbursement mechanism shall be for the Bank to make direct payments from the Loan Account into the BDIF's foreign currency account on the basis of certified documentation evidencing achievement of DLIs.

- Specific modalities for processing withdrawal applications, disbursements and management of the Designated Account are outlined in the Disbursement Letter. The transfers from the IBRD Loan to capitalize BDIF will be reported in the financial section of the semi-annual Progress Reports. Any bank fees charged on receipts will be separately identified in the interim reports submitted to the Bank.
- The Borrower may withdraw an amount not to exceed the equivalent of € 100 million as an advance. However, if in the opinion of the Bank, the DLIs are subsequently not achieved (or only partially achieved) up to the amount of advance, the Borrower will be required to refund the gap between the advance amount and the sum total of the amounts associated with achieved DLIs.
- The Bank shall not be required to make further deposits into the Designated Account or the BDIF foreign currency account if: (i) the Bank, at any time, is not satisfied by evidence and supporting documentation required to justify transfers to BDIF or to certify achievement of DLIs; or (ii) the Borrower shall have failed to furnish to the Bank, within the period of time specified, any of the audit reports required to be furnished to the Bank.
- If the Bank determines at any time that any payment out of the Designated Account or the BDIF foreign currency account was made for an expenditure, which is not an eligible expenditure, or was not justified by the evidence furnished to the Bank, the Borrower shall, promptly upon notice from the Bank, provide such additional evidence as the Bank may request, or deposit into the Designated Account (or, if the Bank shall so request, refund to the Bank) an amount equal to the amount of such payment. Unless the Bank shall otherwise agree, no further deposit by the Bank into the Designated Account or the BDIF foreign currency account shall be made until the Borrower has provided such evidence or made such deposit or refund, as the case may be. Refunds to the Bank made shall be credited to the Loan Account for subsequent withdrawal or for cancellation in accordance with the provisions of the Loan Agreement.

6. **Interim un-audited Financial Reports (IFRs) will be prepared by the BDIF on a semi-annual basis and submitted to the Bank's review as an integral part of the Project progress reports.** These reports will include information of the accountability of project funds alongside progress towards the achievement of DLIs, and shall be relied on for the Bank's internal reporting purposes. For this purpose, the IFRs should present information on the IBRD Loan transfers received during the reporting period and cumulatively, and on the future transfers expected over the next twelve months based on the progress with achieving DLIs. The IFR will also include the interim (unaudited) statement of BDIF's financial position for the respective six-month period, reflecting separately the IBRD Loan transfers. The timeline for submission of

interim financial reports to the Bank will be within 45 days after the end of each reporting period.

7. **The achievement of the DLIs will be certified by the BDIF and verified by the Bank technical team based on the information and documents provided by the Borrower in accordance with agreed verification protocols (see Table 7 below).** Withdrawal applications may be prepared at any time after DLIs are achieved and verified, with amounts received reflected in progress reports covering that period. In addition, auditors acceptable to the Bank will conduct ex-post review of achievement of DLIs as part of the scope of the annual entity audit, extended in line with terms of reference satisfactory to the Bank. The Bank reserves the right to require ex-ante verification by the independent auditor of the DLIs' achievement at any point throughout project implementation.

8. **BDIF's existing annual financial reporting and auditing arrangements are considered acceptable to the Bank.** BDIF will be required to continue the practice of having its annual financial statements prepared in accordance with International Financial Reporting Standards and audited in accordance with International Standards on Auditing by a private audit firm acceptable to the Bank, preferably with relevant banking sector experience. The terms of reference for the entity audit will be extended to include in its scope the independent ex-post verification of the DLIs achievement and of BDIF`s compliance with the below-mentioned financial covenant. Such terms of reference should be agreed with the Bank prior to contracting of the auditor. In the event that in any given calendar year the BDIF's assets become less than the sum of the Bank transfers to the BDIF, the auditors shall confirm in the scope of the entity audit that funds in an amount at least equivalent to the difference between the sum of the IBRD Loan transfers to BDIF and BDIF's assets have been used solely for the purposes of paying compensation on account of its deposit insurance and bank resolution obligations in accordance with the applicable laws and regulations, not including repayment of funds borrowed for the above purposes from entities other than the MoF, or that the difference is due to BDIF's investment policy in line with the legislation. Audited financial statements, together with the management letter, will be submitted to the Bank within six months following the end of each financial year. As required by the Bank's Access to Information policy, the audited financial statements will be publicly disclosed by both BDIF and the Bank.

Procurement arrangements

9. **The project does not trigger any World Bank procurement policies.** The proceeds from the project will not be used for procurement of goods or services, but rather will go entirely towards boosting BDIF's reserves.

Environmental and Social (including safeguards)

10. **The Project does not trigger any World Bank environment or social safeguards policies.** The nature of the project does not lend itself for social impacts. Therefore, the Project has been assigned a Category 'C' in accordance with the World Bank safeguard policy OP/BP/GP 4.01.

Monitoring & Evaluation

11. **The main outcome indicators for the project and the principal results (listed in Annex 1) and DLIs (listed in Annex 2) will serve as the basis for results monitoring and evaluation.** The BDIF will be responsible for collecting the data required for monitoring and evaluation and for verification of the DLIs based on protocols outlined in Table 7 of this Annex. Indicators will be measured against agreed targets and compared to defined baselines. Project progress reports will be prepared by the BDIF on a semi-annual basis. These reports will include BDIF's interim unaudited financial statements.

Role of Partners

12. **The implementation of the financial sector reforms is supported by the World Bank, the EBRD, the IMF, and the EU.** The BDIF has requested a World Bank loan as well as a loan from the EBRD to strengthen its financial and institutional capacity. In addition, the Bulgarian authorities have requested a Financial Sector Assessment Program (FSAP) update, and as part of this exercise, two advance modules on priority topics were carried out in the 2nd quarter of 2015: (i) a joint WB-IMF assessment against Basel Core Principles for Effective Bank Supervision, and (ii) a WB assessment against Core Principles for Effective Deposit Insurance Systems established by the International Association of Deposit Insurers (IADI). Finally, the EU has recently highlighted the importance of decisive policy action on financial sector reform and will monitor further progress in this area.[23]

[23] The EC's most recent in-depth review, released in February 2015, called for a strong, credible and transparent banking supervisor to reduce the risk of imbalances and correct those that have already accumulated. Based on the results of the in-depth review and after the submission of the Convergence Program and the National Reform Program by Bulgaria in April 2015, the EU proposed country-specific recommendations in May 2015, including completing a system-wide independent asset-quality review and a bottom-up stress test of the banking sector by December 2015, in close cooperation with European bodies, reviewing and fortifying banking sector supervision, including by strengthening the bank-resolution and deposit-guarantee frameworks, and improving corporate governance in financial intermediaries, including by tackling concentration risk and related-party exposures. The EU can at any time propose to open an Excessive Imbalance Procedure for Bulgaria, underpinned by the findings of the specific monitoring. If that happens, Bulgaria is obliged to present a corrective action plan (CAP) with specific policy measures and implementation timetable. If the CAP is deemed to be insufficient, Bulgaria can be fined 0.1% of its GDP.

Table 7: Verification Protocols for Disbursement Linked Indicators[24]

DLI	Summary of Verification Protocol
DLI #1.1: Regulation on collecting risk-based premium contributions from banks has been issued.	Official letter from the head of the BDIF confirming that the regulation on collection of risk-based premium has been enacted, with a copy of the relevant decision and regulation issued by the BNB Council attached.
DLI #1.2: Premiums for 2016 are collected by BDIF from banks by May 31, 2016, in the amount set forth in Schedule 4 to the Project's Loan Agreement.	Official letter from the head of the BDIF confirming the amount collected from member banks as annual premium, supplemented by the account statement (or other document considered acceptable by the Bank) showing the corresponding amount has been placed in BDIF's account in BNB.
DLI #1.3: Premiums for 2017 are collected by BDIF from banks by May 31, 2017, in the amount set forth in Schedule 4 to the Project's Loan Agreement.	Official letter from the head of the BDIF confirming the amount collected from member banks as annual premium, supplemented by the account statement (or other document considered acceptable by the Bank) showing the corresponding amount has been placed in BDIF's account in BNB.
DLI #2.1: BDIF recovers from bankrupt banks and transfers into BDIF's account with BNB the amount set forth in Schedule 4 to the Project's Loan Agreement.	Official letter from the head of the BDIF confirming the amount recovered from the bankrupt banks, supplemented by the statement (or other document considered acceptable by the Bank) showing the corresponding amount has been placed in BDIF's account in BNB.
DLI #2.2: BDIF recovers from bankrupt banks and transfers into BDIF's account with BNB the amount set forth in Schedule 4 to the Project's Loan Agreement.	Official letter from the head of the BDIF confirming the amount recovered from the bankrupt banks, supplemented by the statement (or other document considered acceptable by the Bank) showing the corresponding amount has been placed in BDIF's account in BNB.
DLI #3.1: BDIF has entered into an agreement to secure a loan or a backstop liquidity facility, from a creditor other than the World Bank, in the amount of at least € 300 million, to be in place until December 31, 2021, and said agreement has	Official letter from the head of the BDIF confirming the effectiveness of the loan agreement or backstop liquidity facility, supplemented by: (a) the letter from the Creditor summarizing the key terms of legal agreement; and (b) a legal opinion of BDIF counsel confirming that said legal agreement has become effective.

[24] The ex-ante verification of achievement of individual DLIs will normally be conducted by the WB team based on the evidence listed in this table. The WB reserves the right to require ex-ante independent verification by the auditors of the individual DLIs' achievement at any point throughout project implementation.

become effective by September 30, 2016.	
DLI #4.1: BDIF and BNB have signed an updated MOU regulating, inter alia, the flow of information between the two entities.	Official letter from the head of the BDIF confirming the signing of the MOU by both BDIF and BNB, supplemented by a copy of the MOU.
DLI #4.2: Summary of results of independent Asset Quality Review of commercial banks has been shared with BDIF by October 31, 2016.	Official letter from the head of the BDIF confirming that the summary of results of AQR have been provided by the BNB, specifying the type of information that was shared both on the aggregate and bank-by-bank basis.
DLI #5.1: Public awareness survey conducted and public awareness strategy has been approved by BDIF Board.	Official letter from the head of the BDIF confirming that the public awareness strategy has been approved by BDIF Board, supplemented by the copy of the relevant Board decision, and copies of public awareness strategy and the results of the public awareness survey.
DLI #5.2: Contingency plan for BDIF's actions in the case of deposit payout or bank resolution event, based on the BDIF's mandate under the current legal framework, has been adopted by BDIF Board.	Official letter from the head of the BDIF confirming that the contingency plan has been approved by BDIF Board, supplemented by the copy of the relevant Board decision, and copy of contingency plan.

Annex 4: Implementation Support Plan

BULGARIA: Deposit Insurance Strengthening Project

Strategy and Approach for Implementation Support

1. **The Bank's Implementation Support (IS) strategy lays out the activities that the Bank team will implement, as well as the project design and monitoring features that it will adopt, in order to mitigate the most significant risks identified in the Systematic Operations Risk- Rating Tool (SORT).** These risks relate to: (i) the policy risk, that is, the ability and willingness of authorities to pursue the broader reform of banking system and financial safety net drawing on the lessons from the failure of KTB; and (ii) the operational risk stemming from the fact that a number of DLIs depend fully or partially on the actions by parties other than the BDIF, particularly the BNB.

2. **The IS strategy relies on project design features, and policy dialogue and technical assistance along with key development partners as enabling tools for risk mitigation.** The risk mitigating strategy for the above-mentioned risks will be as follows:

(a) *The policy risk relates to the ability and willingness of authorities to pursue comprehensive financial sector reform.* In addition to strengthening the BDIF's financial and institutional capacity, stability of Bulgaria's financial system depends on continuous progress in other technically complex and politically sensitive reform areas, including banking supervision, bank resolution framework, and corporate governance/risk management of domestic banks. As a mitigating factor, there is a universal agreement between all key development partners (EU, IMF, EBRD) on the importance of above-mentioned agenda, which has been central to recent policy discussions with the authorities. It is expected that the WB, along with other development partners, will remain actively engaged, through policy dialogue and technical assistance, in implementing the financial sector reforms outlined in Section I of this PAD.

(b) *The main operational risk stems from Borrower's ability to achieve the proposed DLIs.* This risk is mitigated by the fact that all DLIs are fully consistent with the current legal framework and policy intentions of the BDIF, and other relevant member of Bulgaria's financial safety net. As evidenced by the results of recent IADI assessment, the BDIF has the adequate capacity and tools in place for meeting the agreed DLIs in a timely and quality manner. The Bank team will provide technical support when required, as part of project implementation monitoring.

B. Implementation Support Plan

3. **During project implementation, the Bank's financial management supervision will be conducted through:** (i) desk review of the project's interim un-audited financial reports for each six months period, as part of the regular progress reports, as well as the BDIF's extended scope entity financial statements annual audit; (ii) on-site review with the frequency based on the

assessed project's risk and performance (first supervision in 12 months' time after the Board approval); and (iii) ongoing monitoring of the project's financial management and disbursement arrangements to ensure compliance with the World Bank's minimum requirements. The on-site supervision will include the review of the following areas of the project's financial management: accounting and reporting, internal control procedures and external audits, planning and budgeting, funds flow and staffing arrangements and the supporting documentation for the capitalization transfers. Any changes in the control and operating environment within the BDIF will be monitored, as well as the continuing adequacy of the control framework within BNB and any available audit reports for BNB`s financial statements.. Implementation support and supervision will be performed by the Bank accredited Financial Management Specialist.

4. **The Bank will support project implementation using its own staff.** The Bank team supporting the project will be sourced from Bank offices in Washington DC, Bulgaria and other countries in ECA. In addition, the Bank team will provide support to the BDIF as required. The number of staff weeks envisioned for the first year is 33, with an additional 27 for each of the subsequent two years.

Task Team Skills Mix Requirements for Implementation Support

Time	***Focus***	***Skills Needed***	***Resource Estimate***
First twelve months	Team Leadership	Project management	10 staff weeks (SW)
	Financial Management (FM)	FM Specialist	1 SW
	Technical expertise	Deposit Insurance Expert	4 SW
	Day to day coordination	Operations Officer	10 SW
	Operational Support	Program Assistant	8 SW
12-36 months	Team Leadership	Project management	8 SW
	Financial Management (FM)	FM Specialist	1 SW
	Technical expertise	Deposit Insurance Expert	4 SW
	Day to day coordination	Operations Officer	8 SW
	Operational Support	Program Assistant	6 SW
Other			