

PROJECT INFORMATION DOCUMENT (PID) CONCEPT STAGE

Report No.: PIDC24216

Project Name	Deposit Insurance Strengthening Project (P154219)
Region	EUROPE AND CENTRAL ASIA
Country	Bulgaria
Lending Instrument	Investment Project Financing
Project ID	P154219
Borrower(s)	Bulgarian Deposit Insurance Fund
Implementing Agency	Bulgarian Deposit Insurance Fund
Environmental Category	C-Not Required
Date PID Prepared/ Updated	18-May-2015
Date PID Approved/ Disclosed	28-Dec-2016
Estimated Date of Appraisal Completion	
Estimated Date of Board Approval	18-Mar-2016
Concept Review Decision	Track II - The review did authorize the preparation to continue

I. Introduction and Context

Country Context

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 6.6 percent a year, supported by a favorable external environment, increasing labor productivity, and, last but not least by sizable foreign capital inflows. However, between 2008 and 2013, 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 poorest EU member state with a per capita GDP of around 47 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, little has been done to make public spending more efficient and effective. A challenging external environment and a declining and aging population have undermined Bulgaria's economic progress. Recent banking system instability and a sharp deterioration in the country's fiscal stance (due to ad hoc increases in spending for pensions and health and the support to the banking sector) are putting further strain on the economic outlook, with real GDP growth projected to slow to 1.1 percent in 2015.

Sectoral and Institutional Context

- i. Banking Sector Structure and Performance

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, all of them representing 75.5 percent of total bank assets. There are 2 state-owned banks, representing 3.7 percent of total assets. The top five banks in Bulgaria have a market share of 54.2 percent of total bank assets, with the largest two owned by Italian and Hungarian parents, with 17.4 percent and 11.7 percent market shares, respectively. However, by country of origin, Greek-owned banks have the largest presence, with 4 banks having a combined asset share of 23.1 percent, including the 4th and 5th largest. Finally, there are 8 domestically owned banks with a combined asset share of 20.8 percent, including the third largest bank (First Investment Bank (FIB)).

The banking sector shows relatively high levels of financial depth, but figures have somewhat reduced in 2014. Assets and loans to GDP in 2014 stood at 108.7 percent and 65.8 percent respectively, 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 67.6 percent of GDP (the highest among ECCU5 countries which are WB clients). Thanks to a stable inflow of funds, mainly from household deposits, the banking system's total assets had increased by 4 percent in 2013, but it decreased by 0.7 percent during the course of 2014, given the uncertainties caused by the failure of Corporate Commercial Bank (KTB). 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 lost external funding equivalent to 1.9 percent of GDP in 2014. From the peak in late 2008, the decline in foreign liabilities has been equivalent to 14.7 percent of GDP. However, domestic deposit mobilization increased by 16.4 percent of GDP during the same period, enough to compensate the loss of foreign funding, driven by households' high propensity to save.

The funding structure of banks is majority deposit-based, with deposit interest rates differing between domestic and foreign-owned banks. Total customer deposits represent 75 percent of total liabilities (including equity), followed by capital and reserves (12.7 percent), interbank deposits (9.2 percent) and subordinated debt (1.2 percent). Other types of borrowing represented only 0.5 percent of total funding sources. In terms of currency, more than 90 percent of interbank deposits, borrowing and subordinated debt are denominated in foreign currency (predominantly Euro), while only 42.6 percent of customer deposits are (down from 43.2 percent in 2013). Domestic-owned banks are offering higher interest rates (above 3 percent on average) than foreign-owned banks (1-1.5 percent on average) in order to attract more deposits, as they do not have access to parent funding.

Credit growth has been modest in recent years, reflected also in high liquidity in the overall banking system. Private credit grew just 0.3 percent year-on-year in 2013, lower than previous years. During 2014, credit growth accelerated to levels between 2 and 2.5 percent, but the effects on market confidence from the failure of KTB and the weak economy weighed negatively on the demand for loans (corporate and households) and is challenging banks' ability to generate profits from this core activity. The ratio of liquid assets to total assets has steadily increased reaching 30.1 percent by end 2014, despite the temporary liquidity difficulties faced by some banks following the failure of KTB. The upward trend in liquidity shows the few opportunities for business development in the banking sector, as mobilized deposits are parked in low-yielding assets instead of being allocated to productive purposes through the provision of credit.

The long-standing asset quality problem is not helping jumpstart credit growth in a sustainable manner. The NPL ratio (overdue by more than 90 days) remains high (although lower than in many other economies of South-East Europe) at 17.3 percent and 17.7 percent in 2013 and 2014,

respectively, with the corporate sector registering a 20 percent of nonperforming credit. Mortgage loans, which represent almost half of total household loans, also show increasing NPLs, standing at 16.8 percent in 2014, up from 10.9 percent in March 2011. NPLs are expected to continue to be sticky due to subdued economic growth prospects. Credit risks are amplified by significant volume of restructured loans not captured in official NPL data.

Capital adequacy is relatively sound, but may mask significant differences between banks. As of September 2014, Tier 1 and total capital adequacy ratios (excluding KTB) were high, at 19.9 percent and 22.2 percent, respectively, although anecdotal evidence suggests lower figures for domestically owned banks. The ratios have increased markedly since end-2013 due to the Capital Requirements Regulation and Directive (CRR/CRD IV) implementation, as “specific” provisions are no longer deducted from regulatory capital. The provisions will be gradually phased-out, but local authorities are taking steps to preserve appropriate buffers against problem loans. In particular, a 3 percent systemic risk buffer and a 2.5 percent capital conservation buffer were set to prevent the erosion of capital already accumulated in banks and to preserve financial stability in the absence of active monetary policy under a currency board arrangement, amid deteriorating asset quality and weak profitability. ROA of 0.9 percent and ROE of 6.9 percent in 2014 remained largely unchanged in comparison to previous years, as banks are beginning to make efforts to reduce deposit and in turn lending rates to attract more credit demand.

ii. The Banking Crisis of 2014

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. Following a negative media campaign, 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 supervision on June 20, 2014. Within days, First Investment Bank (FIB) -the 3rd largest bank and the largest domestically-owned bank- faced a deposit run, losing about 10 percent of its deposits on a single day as liquidity pressures started to spread to the rest of the banking system. What made the crisis particularly acute was the significant political uncertainty, following the resignation of the government earlier in the month.

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 of up to BGN 3.3 billion (€1.65 billion or 4 percent of GDP) which provided 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. FIB alone was granted a state deposit of BGN 1.2 billion (€600 million). In late November, FIB repaid BGN 300 million (€150 million) and the remaining BGN 900 million (€450 million) were extended until May 2016. The anti-crisis package coupled with consistent messages to the public helped to reverse the outflow of deposits.

Limited range of resolution tools resulted in lengthy conservatorship period for KTB during which depositors did not have access to their savings. The BNB did not choose to utilize the bridge bank or purchase and assumption resolution options for KTB, citing the legal constraints as the main reason. At the same time, according to the existing legislation the Bulgarian Deposit Insurance Fund (BDIF) could only start reimbursing depositors once the banking license of a failed institution is withdrawn. This clause, and the absence of a back-up funding mechanism for BDIF, led to a five months delay with payment to insured depositors, due to which Bulgaria was officially notified by EC to be in infringement of the EU rules.

The BNB finally revoked KTB’s license in November 2014 on the basis of its insolvency, thus triggering the payment of guaranteed deposits. Based on the results of an assessment carried out by external auditors, KTB’s 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 of license revocation finally unlocked the repayment of KTB's BGN 3.8 billion (€1.9 billion) of guaranteed deposits (for up to BGN 196,000, or €100,000 per deposit account) by the BDIF. Meanwhile, KTB is expected to enter into bankruptcy procedure under the BDIF's oversight.

Repayment 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 repaid, through its agent banks, around €1.9 billion (> 95 percent of KTB's insured deposits) to 101,740 depositors. Only BGN 200 million (€100 million) were left in BDIF's reserves at that time, although an additional BGN 250 million (€25 million) came in as annual premium at the end of March.

iii. Government Measures to Preserve Financial Stability

The failure of KTB gave rise to doubts about the health of other parts of the financial sector, particularly of other domestic-owned 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.

Bulgaria has manifested its interest in joining the EU's Single Supervisory Mechanism (SSM). Commitment to join the SSM was included 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 signaled that all Bulgarian banks will need to undergo a comprehensive Asset Quality Review by external auditors. According to the latest information from BNB, this exercise is expected to begin by end-2015. However, joining the SSM will not result in access to ECB liquidity.

In parallel, the authorities have accelerated the efforts to transpose EU's new financial sector directives into Bulgarian 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 Banking Law, the Bank Bankruptcy Law, and the Deposit Guarantee Act expected to be drafted by mid-2015. Important policy issues to be addressed include institutional setup of a Resolution Authority (which is likely to stay under the BNB), the creation of a Resolution Fund, and the expansion of resolution tools (see Box 1).

Box 1. The Bank Recovery and Resolution Directive (BRRD)

The BRRD sets the conditions for a compatible bank resolution regime in the EU. Specifically, the BRRD: a) requires banks to draw and resolution authorities to approve recovery and resolution plans, b) gives power to bank supervisors to intervene early on if an institution faces financial distress, c) provides resolution tools in case of distress, including bail-in mechanisms, and d) provides for a framework for cooperation in cases of resolution of cross-border banking groups. EU countries implementing the BRRD will still have to make decisions on certain aspects where the Directive leaves room for discretion, such as:

1. The institutional setup of the Resolution Authority (RA): The BRRD allows –but does not require– the Supervisory Authority (SA) to be also the RA, and provides for operational and functional separation of two functions.
2. The mandate of the RA: The BRRD provides for the RA to be empowered to use “resolution tools” for banks, while bank liquidation can be done separately by a different entity and under national insolvency laws.

3. The creation of a Resolution Financing (RF): BRRD requires financing by the industry to fund the resolution actions, although there does not have to be a separate legal entity managing this money.

4. The preferred creditor status of the RF: Although the BRRD provides for a preferred creditor status for deposit insurance fund and covered deposits in liquidation and under resolution (bail-in), the RF does not have such status in case of liquidation of a bank.

In response to the EC's criticism of delayed repayment of KTB's insured deposits, a new Bank Deposit Guarantee Act has been drafted and is currently being discussed in Parliament. The draft law, which has already gone through the first reading in Parliament, seeks to transpose the EU's recent Directive on Deposit Guarantee Schemes. In particular, the draft envisages that payment of insured deposits should be done within seven business days after a bank's license was revoked or the BNB declared the unavailability of deposits.

Finally, the Bulgarian authorities have requested a Financial Sector Assessment Program (FSAP) update. As part of this exercise, two advance module on priority topics will be carried out in the fourth quarter of FY15: 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). The remaining modules of the FSAP are expected to be carried out in early 2016.

Relationship to CAS

The proposed project is fully consistent with the draft Systematic Country Diagnostic's (SCD) which calls for safeguarding macroeconomic and financial stability. In order to restore confidence and attract needed private investment, addressing weaknesses in banking regulation and supervision are identified 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 depositors.

In turn, safeguarding macroeconomic and financial stability is essential for growth and shared prosperity to be sustainable. In most countries, high volatility from macroeconomic and financial sources has been found to be most damaging for small firms and poor households, especially in countries like Bulgaria that have yet to put in place effective safety nets to help households cope with income volatility. Ensuring that the BDIF is able to effectively function as part of the financial safety net helps increasing confidence in the banking system, which in turn stimulates higher domestic savings that can be utilized for investments leading to job creation and shared prosperity. Therefore, the proposed project contributes to the World Bank's twin goals.

Finally, the project is of particular relevance given it will be the World Bank's first lending project in Bulgaria in many years. It should therefore be seen as an opportunity to re-engage in the policy dialogue with the authorities on highly relevant financial sector agenda, and to position the WB as a relevant partner for the economic development of the country.

II. Proposed Development Objective(s)

Proposed Development Objective(s) (From PCN)

The Project Development Objective is to help maintain the confidence of depositors and strengthen the financial safety net, by improving the financial and institutional capacity of the Bulgarian Deposit Insurance Fund (BDIF).

Key Results (From PCN)

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

- Ensuring adequate financial inflows into the BDIF during the course of the project;
- Improving the capacity of the BDIF to perform its legally-mandated functions (deposit payout and overseeing the liquidation of insolvent banks).

III. Preliminary Description

Concept Description

The proposed operation responds to the request from authorities for the WB's financial support for BDIF in order to maintain confidence in the market. The Ministry of Finance (MOF) has indicated their preference that the WB enters into a financing agreement directly with BDIF, under a sovereign guarantee.

Two possible instruments have been considered by the team: (i) investment loan with contingent financing; and (ii) investment loan with direct financing based on disbursement linked indicators (DLIs).

Strengthening the market confidence by promptly rebuilding BDIF's financial capacity should be the key consideration in choosing the instrument of WB's engagement. In parallel to providing prompt financing, the WB engagement should ideally support the BDIF's further institutional development. Possible areas for improvement noted during pre-identification mission include: (i) achieving and maintaining a more prudent funding ratio using various sources (bank premiums (including risk-based and extraordinary ones), recoveries from insolvent banks, external creditors, and government back up funding, if necessary); (ii) improving BDIF's independence as an important player in the financial safety net and information sharing between BDIF and other financial safety net participants; (iii) improving the performance of BDIF's mandate to pay-out deposits within a shorter pay out timeframe; and (iv) recover assets from insolvent banks.

In the case of Bulgaria, the team's preferred option would be a results-based IPF of at least €200 million to replenish the BDIF's reserves. The funds to be provided under the results-based IPF meet the OP/BP 10.00 productive use requirement as funding for a Deposit Insurance Scheme helps to increase confidence in the financial system and thus maintain macroeconomic stability. The instrument would be disbursed using the results of the upcoming assessment against IADI Core Principles.

IV. Safeguard Policies that might apply

Safeguard Policies Triggered by the Project	Yes	No	TBD
Environmental Assessment OP/BP 4.01		×	
Natural Habitats OP/BP 4.04		×	
Forests OP/BP 4.36		×	
Pest Management OP 4.09		×	
Physical Cultural Resources OP/BP 4.11		×	
Indigenous Peoples OP/BP 4.10		×	
Involuntary Resettlement OP/BP 4.12		×	
Safety of Dams OP/BP 4.37		×	
Projects on International Waterways OP/BP 7.50		×	

Projects in Disputed Areas OP/BP 7.60		x	
---------------------------------------	--	----------	--

V. Financing (in USD Million)

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

VI. Contact point

World Bank

Contact: Alexander Pankov
 Title: Lead Financial Sector Speciali
 Tel: 473-7128
 Email: apankov@worldbank.org

Borrower/Client/Recipient

Name: Bulgarian Deposit Insurance Fund
 Contact: Radoslav Milenkov
 Title: Chairman of the Management Board
 Tel: 0035929531217
 Email: contact@dif.bg

Implementing Agencies

Name: Bulgarian Deposit Insurance Fund
 Contact: Radoslav Milenkov
 Title: Chairman of the Management Board
 Tel: 0035929531217
 Email: contact@dif.bg

VII. For more information contact:

The World Bank
 1818 H Street, NW
 Washington, D.C. 20433
 Telephone: (202) 473-1000
 Web: <http://www.worldbank.org/projects>