Project Information Document/ Integrated Safeguards Data Sheet (PID/ISDS)

Concept Stage | Date Prepared/Updated: 11-Aug-2016 | Report No: PIDISDSC18528

BASIC INFORMATION

A. Basic Project Data

Country	Project ID	Parent Project ID (if any)	Project Name
Bosnia and Herzegovina	P158387		Banking Sector Strengthening Project (P158387)
Region	**Estimated Appraisal Date**	**Estimated Board Date**	**Practice Area (Lead)**
EUROPE AND CENTRAL ASIA	Nov 15, 2016	Jul 15, 2017	Finance & Markets
Lending Instrument	**Borrower(s)**	**Implementing Agency**	
Investment Project Financing	BiH Ministry of Finance and Treasury,Deposit Insurance Agency	Republika Srpska Ministry of Finance,FBiH Ministry of Finance,FBiH Banking Agency,RS Banking Agency	

Financing (in USD Million)

Financing Source	Amount
International Bank for Reconstruction and Development	80.00
Total Project Cost	**80.00**

Environmental Assessment Category	Concept Review Decision
C-Not Required	Track II-The review did authorize the preparation to continue

Other Decision (as needed)

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B. Introduction and Context

Country Context

Following modest post-crisis recovery, Bosnia and Herzegovina (BiH) continues to struggle with structural problems that undermine economic growth. Following the global financial crisis and subsequent Eurozone crisis leading to a double-dip contraction of the economy, the country experienced the beginning of a moderate economic recovery in 2013 when growth reached 2.4 percent. This was interrupted by the floods of May 2014 with growth picking up again in 2015 to an estimated 3.2 percent. At the same time, the current account balance narrowed down from -7.5 percent of GDP in 2014 to -5.6 percent of GDP in 2015 and this trend is expected to continue in 2016. The fiscal deficit is foreseen to further narrow and stay below 1 percent of GDP in 2016 with some key structural rigidities (wage freeze and better targeted social assistance) in public expenditures addressed. However, despite some improvements, the private sector is still hampered by a lackluster business environment, high labor taxes, inflexible labor market policies, uneven transport infrastructure, energy inefficiency and other constraints. Meanwhile, high unemployment at around 28 percent, especially among youth, and low productivity of capital are among the factors that constrain income growth in the medium-term.

Sectoral and Institutional Context

The BiH banking sector dominates the financial sector and is primarily foreign owned. There are 25 banks in BiH accounting for around 87 percent of financial system assets, which are equivalent to 85 percent of GDP as of end-2015. The banking system comprises mostly foreign subsidiaries—91 percent of the banking sector assets, while domestically-owned and state-owned banks account for 7 and 2 percent respectively. The five largest banks represented about half of banking sector assets in 2015. The number of banks operating in BiH remains remarkably high relative to peer countries with room for further consolidation.

The banking sector is still dealing with the aftershocks of the global financial crisis that have weakened financial sector asset quality and profitability. Following credit growth of an annual average of 20 percent between 2004 and 2008, private sector credit growth turned negative at the end of 2009 and since then has grown at an annual rate of only 2-3 percent. The system-wide non-performing loan (NPL) ratio – although on a slightly declining trend – remained high at 13.7 percent at end-2015, reflecting the impacts of the financial crisis, lax credit practices, and weak debt recovery mechanisms which hamper banks' efforts to work out NPLs. Profitability remains subdued with return on equity (RoE) and return on assets (RoA) standing at 2.4 and 0.3 percent respectively. Although above the regulatory minimum of 12 percent, the system's capital adequacy ratio (15 percent at end-2015) has been on a declining trend since end 2013, with wide variations between banks.

Against this backdrop, it is essential that the financial safety net is further strengthened by developing a comprehensive resolution regime to deal with the weakest banks either through recovery or resolution/liquidation. A number of key elements in the financial safety arrangements are either missing or not adequately developed. Further enhancement of the deposit insurance arrangements is needed as part of the strengthening the overall bank resolution framework. Banking regulation and supervision have improved during the last decade, but a number of important shortcomings remain. Lack of adequate governance and risk management has contributed to the current number of problem banks. Fragmentation of the institutional framework and the lack of coordination and information sharing between stakeholders are delaying needed reforms and improvements, and result in duplications of effort that waste scarce supervisory resources.

Relationship to CPF

The proposed project is consistent with the 2016-2020 Country Partnership Framework (CPF) which calls for safeguarding macroeconomic and financial stability as well as fostering access to finance. The CPF states that maintaining the stability of the financial sector is a fundamental condition for maintaining macro-fiscal stability in the country. The CPF is based on the findings of the 2014 Financial Sector Assessment Program (FSAP) highlighting a number of banking sector vulnerabilities including high levels of NPLs, weaknesses in the domestic banks, gaps in the financial safety net, and need to strengthen the framework for bank resolution. The banking sector in BiH plays a key role in providing resources to the most productive sectors of the economy and therefore contributes to growth and employment in line with the World Bank twin goals.

C. Proposed Development Objective(s)

The Project Development Objective (PDO) is to help strengthen the banking sector in BiH and maintain confidence of depositors.

Key Results (From PCN)

The project entails two Components:

Component 1: Strengthening the banking sector by improving bank regulation and supervision, establishing the new bank resolution framework and enhancing coordination and cooperation among regulatory and supervisory authorities. The expected results are an upgraded institutional, regulatory and supervisory framework that improves the soundness and stability of the banking sector and upgrades supervisory capacity and cooperation between the banking agencies as well as introduction of a bank resolution framework in line with international best practice.

Component 2: Improving the financial and institutional capacity of the Deposit Insurance Agency (DIA). The expected results would be focused on ensuring adequate financial inflows into the Deposit Insurance Fund (DIF) during the course of the project and improved capacity of the DIA to perform its legally mandated deposit payout function in the event of a bank failure.

D. Concept Description

The project entails two Components.

Component 1 is built around four components that focus on strengthening the banking sector through improving bank regulation and supervision, establishing a bank resolution framework and enhancing coordination and cooperation.

Subcomponent 1 focuses on strengthening banking sector regulation and supervision aligned with Basel II/III regime. As part of this Subcomponent, the project will support the Banking Agencies in further strengthening capital and liquidity requirements to enhance banks' ability to withstand solvency and liquidity shocks. Moreover, the project will assist the authorities in developing a revised supervisory methodology aligned with the EU supervisory review and evaluation processes (SREP). Lastly, the Disbursement Linked Indicators (DLI) supports the alignment of supervisory reporting with European reporting frameworks (COREP- "Common Reporting" and FINREP - "Financial Reporting") which will ensure further harmonization and convergence of supervisory reporting standards for banks across BiH and more broadly the EU.

Subcomponent 2 focuses on addressing weaknesses in the banking sector. As part of the DLI, the project will support the enforcement of the results of the 2016 asset quality reviews (AQRs) either by mandatory time bound corrective action programs or resolution/liquidation programs for all undercapitalized banks.

As part of Subcomponent 3, the project will support the authorities in implementation of the bank resolution framework as foreseen in the draft Banking Laws. This DLI focuses on preparation and adoption of a key set of bylaws and decisions related to bank recovery and resolution (adoption by each Agency would take place after enactment of the new Banking Laws), establishment and operationalization of dedicated bank resolution units within RS Banking Agency (BARS) and the Federation Banking Agency (FBA), adoption of an internal assessment methodology for recovery plans, subsequent assessment of recovery plans to be submitted by all banks to FBA and BARS and preparation of resolution plans.

Subcomponent 4 supports enhanced coordination among regulatory and supervisory agencies. The respective DLI foresees an update of the MOU between the FBA, BARS and the DIA once the new bank resolution framework is enacted to ensure that information and coordination within the financial safety net is strengthened in the area of deposit insurance and bank resolution.

Component 2 is focused on improving the financial and institutional capacity of the DIA. Component 2 is contingent on a financing needs assessment to be conducted by the DIA and the WB team in the Fall of 2016. Only then - once the current round of AQRs are completed – can an informed decision be taken on the underlying risks and consequently the capitalization needs of the DIA.

The project will be designed as a results focused hybrid IPF with two separate loan agreements, one for the DIA and one for the entity level Component. The loans focus on achieving and sustaining results and are therefore seen to be the best instrument to support the authorities in implementing key reforms identified in the 2014 FSAP and the authorities' own reform agendas. The proposed instrument will help meet core client's need to strengthen the institutional capacity of the banking agencies in the two entities and the DIA. In addition, it would allow an increase in the DIF's funding as well as the disbursement of project funds to the Entities' Treasury accounts based on the achievement of Entity-specific sets of Disbursement Linked Indicators (DLIs).

SAFEGUARDS

A. Project location and salient physical characteristics relevant to the safeguard analysis (if known)

Country-wide. The project is not expected to entail any environmental, social or other safeguards issues.

B. Borrower's Institutional Capacity for Safeguard Policies

Not applicable

C. Environmental and Social Safeguards Specialists on the Team

Esma Kreso, Ifeta Smajic

D. Policies that might apply

Safeguard Policies	Triggered?	Explanation (Optional)
Environmental Assessment OP/BP 4.01	No	The scope of the Project does not include any physical works or activities that may impact the environment. Furthermore, any activities proposed under the assistance of the Project will not result in civil works, reconstruction, renovation or new construction. The policies are related solely to the banking sector and should have no repercussions on the environment or natural resources. A checklist EMP will be used in case hardware installation under the project shall require any physical works or refurbishment.
Natural Habitats OP/BP 4.04	No	
Forests OP/BP 4.36	No	
Pest Management OP 4.09	No	
Physical Cultural Resources OP/BP 4.11	No	
Indigenous Peoples OP/BP 4.10	No	
Involuntary Resettlement OP/BP 4.12	No	There will be no land acquisition within the project.
Safety of Dams OP/BP 4.37	No	
Projects on International Waterways OP/BP 7.50	No	
Projects in Disputed Areas OP/BP 7.60	No	

E. Safeguard Preparation Plan

Tentative target date for preparing the Appraisal Stage PID/ISDS

Nov 07, 2016

Time frame for launching and completing the safeguard-related studies that may be needed. The specific studies and their timing should be specified in the Appraisal Stage PID/ISDS

Not applicable

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APPROVAL

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