Document of
The World Bank

FOR OFFICIAL USE ONLY

Report No. 87910-UA

INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

PROGRAM DOCUMENT

ON A PROPOSED LOAN

IN THE AMOUNT OF US$500 MILLION

TO UKRAINE

FOR THE

FIRST PROGRAMMATIC FINANCIAL SECTOR DEVELOPMENT POLICY LOAN

July 18, 2014

Finance and Markets Global Practice
Belarus, Moldova and Ukraine Country Unit
Europe and Central Asia Region

UKRAINE: GOVERNMENT FISCAL YEAR
January 1 – December 31

CURRENCY EQUIVALENTS
(Exchange Rate Effective as of June 30, 2014)

Currency Unit = Ukrainian Hryvnia (UAH)
US $1.0 = UAH 11.75

ABBREVIATIONS AND ACRONYMS

CAR	Capital Adequacy Ratio
CPS	Country Partnership Strategy
D-SIB	Domestic Systemically Important Banks
ECB	European Central Bank
DGF	Deposit Guarantee Fund
DPL	Development Policy Loan
DSA	Debt Sustainability Analysis
EBRD	European Bank for Reconstruction and Development
ECA	Europe and Central Asia
ECAPOV	ECA Poverty Database
FDI	Foreign Direct Investment
FX	Foreign Exchange
FY	Fiscal Year
GDP	Gross Domestic Product
GoU	Government of Ukraine
IBRD	International Bank for Reconstruction and Development
IFIs	International Financial Institutions
IMF	International Monetary Fund
LA	Loan Agreement
M&A	Mergers and Acquisitions
MoF	Ministry of Finance
MoU	Memorandum of Understanding
NBFI	Non-Bank Financial Institutions
NBU	National Bank of Ukraine
NPL	Non-performing Loan
PEFA	Public Expenditure and Financial Accountability
PFM	Public Financial Management
ROA	Return on Assets
ROE	Return on Equity
SBA	Stand-By Arrangement
TA	Technical Assistance
UAH	Ukraine Hryvnia
USAID	United States Agency for International Development
US$	United States Dollar

Vice President:	Laura Tuck
Country Director:	Qimiao Fan
Senior Practice Director:	Gloria M. Grandolini
Practice Manager:	Aurora Ferrari
Task Team Leader:	Alexander Pankov

UKRAINE

FIRST PROGRAMMATIC FINANCIAL SECTOR DEVELOPMENT POLICY LOAN

TABLE OF CONTENTS

Ukraine First Programmatic Financial Sector Development Policy Loan was prepared by a World Bank Group team consisting of (in alphabetical order): Rinku Chandra (GFMDR); Sebastian Eckardt (GMFDR); Olesya Gafurova (ECCU2); Anastasia Golovach (GMFDR); Daria Gulei (ECCUA); Yevhen Hrebeniuk (GFMDR); Elena Kantarovich (GFMDR); Maiada Kassem (CTRLA); Caterina Ruggeri Laderchi (GPVDR); Colleen Mascenik (GFMDR); Lalita Moorty (GMFDR); Alexander Pankov (Task Team Leader, GFMDR); Lalit Raina (GFMDR); Julie Rieger (LEGLE); Luis Schwarz (CTRLA); Steven Seeling (Consultant); Moses Wasike (GGODR); and Vahe Vardanyan (GFMDR). We gratefully acknowledge guidance from: Laura Tuck (ECAVP), Qimiao Fan (ECCU2); Gloria Grandolini (GFMDR); Gerardo Corrochano (LCC1C); Sebastian-A Molineus (GFMDR); Hans Timmer (ECACE); Aurora Ferrari (GFMDR); Paloma Anos Casero (GTCDR); Alejandro Cedeño (ECCU2); and Francois Nankobogo (ECADE).

SUMMARY OF PROPOSED LOAN AND PROGRAM

UKRAINE

FIRST PROGRAMMATIC FINANCIAL SECTOR DEVELOPMENT POLICY LOAN

Borrower	Ukraine
Implementation Agency	Ministry of Finance (MoF), National Bank of Ukraine (NBU) and Deposit Guarantee Fund (DGF)
Financing Data	IBRD Loan Terms: US$ denominated IBRD loan plus variable spread, with a total maturity of 16 years, including 7 years of grace. Amount: US$500 million
Operation Type	Programmatic (1of 2); Single tranche
Pillars of the Operation And Program Development Objective(s)	The proposed Program Development Objective is to: (i) strengthen the operational, financial and regulatory capacity of the DGF for the resolution of insolvent banks; (ii) improve the solvency of the banking system through implementation of bank recapitalization/restructuring plans and timely enforcement action; and (iii) strengthen the legal and institutional framework to improve resiliency and efficiency of the banking system. The operation is anchored in nine prior actions, structured around three pillars. The first pillar focuses on urgent actions that are necessary to minimize the risk of a loss of depositor confidence, through ensuring that the DGF can adequately perform its critical bank resolution and insured deposit payout functions. The second pillar focuses on ensuring that adequate solvency of banking system is maintained through implementation of bank specific recapitalization/restructuring plans. Finally, the third pillar supports legal and institutional reforms necessary to improve the resiliency and efficiency of the banking system.
Result Indicators	Pillar 1: • DGF maintains adequate financial capacity (funding ratio) • Number of bank resolution plans implemented by DGF Pillar 2: • Banking system adequately capitalized (percent CAR) Pillar 3: • Consolidation of banking sector in Ukraine (number of banks) • Adoption of recovery plans by domestic systemically important banks
Overall risk rating	High
Operation ID	P150677

IBRD PROGRAM DOCUMENT FOR A PROPOSED

FIRST PROGRAMMATIC FINANCIAL SECTOR DEVELOPMENT POLICY LOAN TO UKRAINE

1. INTRODUCTION AND COUNTRY CONTEXT

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

2. **Given the significant risks in the banking sector, the first FSDPL operation is being prepared on an accelerated basis.** The Ukrainian authorities have prioritized the urgent need to maintain depositor confidence in the banking sector in order to minimize the potential cost of bank runs to the economy and the population. Swift policy action and financial support are especially critical given the need to strengthen the DGF, the key player in the financial safety net responsible for insured depositor payout and the resolution of insolvent banks. The second operation in the series (FSDPL2) is planned for the early 2015, and will focus on the implementation of the bank recapitalization and restructuring program based on the results of independent diagnostic studies, as well as longer term reforms to improve resiliency and efficiency of the banking sector.

3. **The ongoing political, economic and security crisis is putting Ukraine's banking system under severe stress.** As a sign of eroding public confidence, the banking system lost around 12.6 percent of Ukrainian Hryvnia (UAH) and 26.1 percent of foreign exchange (FX) retail deposits in the first six months of 2014. The situation is exacerbated by long-standing structural problems within the banking system, including an overhang of non-performing loans (NPLs) left from the 2008-09 crisis and weak governance in many domestically owned banks.

4. **FSDPL1 is prepared against the backdrop of considerable political uncertainty.** The political unrest that began in November 2013 culminated in a change of Government in late February 2014 and election of a new President three months later. While the successful presidential elections and recent signing of the Deep and Comprehensive Free Trade Agreement with the European Union are expected to improve political stability, there is a high probability of parliamentary elections in the fall of 2014. Ukrainians now have heightened expectations that the new authorities will provide the enabling conditions, including financial sector stability, for growth and job creation, promote transparent governance, and decrease the level of public sector corruption. At the same time, the geopolitical tensions over the future direction of the country contribute to an extremely tense security environment, particularly in eastern Ukraine.

5. **Poverty in Ukraine has been declining and consumption growth among the bottom**

40 percent of the population has been significant over the past few years. As a result of rapid economic growth, particularly prior to the global financial crisis, the poverty rate declined from 14.7 in 2006 to 3.9 percent in 2012[1]. From 2007 to 2012, consumption for the bottom 40 percent grew by more than two times that of the rest of the population (3.9 percent vs. 1.5 percent). This reflected a higher growth in wage income than for the average of the population (24 percent vs. 19 percent), driven by improvements in the education profile of those in the bottom 40 percent, and a slight decrease in the share of unemployed over the period. Higher growth in social assistance receipts and child benefits also played a role. Despite these improvements, the bottom 40 percent still lags behind the rest of the population in terms of skills and employment performance.

6. **FSDPL1 is a key part of the World Bank Group**'s **support to achieving the twin corporate goals of reducing extreme poverty and boosting shared prosperity in Ukraine.** The measures supported by FSDPL1 focus on urgent actions that are necessary to minimize the potential impact of the significant risks in the banking sector. Past global experience has shown that financial crises lead to an increase in poverty and significantly impact the bottom 40 percent. The policies supported by the FSDPL1, as well as the planned FSDPL2, will contribute to preserving the social gains achieved in recent years and positioning the financial sector to support economic growth in Ukraine in the medium term.

7. **FSDPL1 is also aligned with the strategic directions set out in the FY12-16 Country Partnership Strategy (CPS), which envisaged a calibrated World Bank Group engagement depending on the pace and strength of reforms.** One of the key policy areas identified in the CPS was financial sector stability and development. Due to the lack of a sustainable macroeconomic framework and inconsistent reforms in the past five years, the World Bank has not provided budget support to Ukraine to support financial sector reforms. Instead, the policy dialogue was sustained through technical assistance based on a programmatic financial sector TA program. This DPL series builds on this long-standing engagement.

8. **In conjunction with the financial sector reforms supported by this operation, a complementary Fiscal Adjustment and Institutional Reform DPL series supports difficult but much-needed structural reforms to put the economy on a sustainable growth path.** The first operation of the Fiscal Adjustment and Institutional Reform DPL series was approved by the Board of Executive Directors on May 22, 2014 and aims to: (i) promote good governance, transparency, and accountability in the public sector; (ii) strengthen the regulatory framework and reduce costs of doing business; and (iii) reform inefficient and inequitable utility subsidies while protecting the poor. In addition, the content of the FSDPL series is fully aligned with the Stand-By Arrangement (SBA) with the International Monetary Fund (IMF) which was approved by the IMF Board of Executive Directors on April 30, 2014.

[1] Based on the ECA Poverty Database (ECAPOV) methodology and the US$5/day poverty line. Recorded inequality fell from a Gini coefficient of 0.29 at the beginning of the decade to 0.25 in 2012. Such low levels of inequality suggest that the survey is underestimating inequality. Indeed it is very likely that the survey does not capture developments at the top end of the income distribution. Estimates of the under coverage of the distribution at the top vary and are as high as 30 percent.

2. MACROECONOMIC POLICY FRAMEWORK

9. **Despite high risks, the macroeconomic framework – anchored in the IMF SBA- is adequate for the FSDPL1 to proceed.** Faced with economic stagnation, mounting fiscal and external pressures, and a fragile banking system, the authorities undertook urgent measures to stabilize the economy. In late February 2014, to avoid an imminent balance of payment crisis, the authorities switched to a flexible exchange rate regime, initiated fiscal consolidation, and requested an SBA with the IMF which was approved on April 30, 2014. The World Bank Board also approved the multi-sector DPL1 on May 22 to support structural reforms. While these measures have resulted in initial signs of stabilization, risks remain high. Escalating violence in eastern Ukraine, heightened geopolitical tensions, banking sector instability and slowdown in reforms could result in a deeper and more protracted recession, hamper macroeconomic adjustment, and put at risk the sustainability of the macroeconomic framework.

2.1 RECENT ECONOMIC DEVELOPMENTS

10. **Against the backdrop of uncertainty and the ongoing macroeconomic adjustment, real GDP declined by 1.1 percent in the first quarter of 2014.** After a deep contraction in 2009 precipitated by the global economic crisis, Ukraine experienced a modest recovery in 2010-2011 followed by economic stagnation during the past two years due to lack of structural reforms, inconsistent macroeconomic policies, declining investment, and weak external demand (Figure 1). As a result, real GDP remained below its 2007 level in 2013 and lagged its regional peers (Figure 2). Deepening instability in the east and ongoing macroeconomic adjustment continues to affect growth negatively in 2014. Preliminary estimates show that real GDP declined by 2.3 percent in the first five months, implying sharper decline in April-May due to problems in the east. This decline was driven by falling industrial production (-4.6 percent, y/y), construction (-6.5 percent, y/y), and wholesale and retail trade (-9.8 percent and -7.7 percent y/y respectively), which was only partially offset by growth in agriculture (4.7 percent, y/y) and transport (2.1 percent, y/y).

11. **Following a sharp devaluation in February 2014, the nominal exchange rate has since stabilized.** Exchange rate pressures intensified in the first two months of 2014 against the backdrop of political turmoil, rising geo-political tensions and the suspended disbursement of the second tranche of US$2 billion from the Russian Federation initially scheduled for late January. These pressures were compounded by outflows of deposits from banks due to heightened devaluation expectations and political uncertainty. By late February, faced with rapidly declining reserves, the NBU switched to a flexible exchange rate regime, setting the official exchange rate based on the average interbank rate. Consequently, the Hryvnia lost a quarter of its value and has since fluctuated between UAH11-12/US$.

12. **After widening steadily over the past few years, the external current account has started to adjust.** By end 2013, the current account deficit widened to 9.2 percent of GDP as a result of a weak external environment, an overvalued exchange rate and loose fiscal policies. In the wake of the currency devaluation and fiscal tightening, the current account deficit adjusted sharply to 2.1 percent of GDP in the first quarter of 2014, compared to 8 percent of GDP during the first quarter the year before. Exports continued to decline due to weak external conditions, although at a slowing pace in value terms due to the devaluation. Meanwhile, imports fell

sharply (-21.6 percent during first quarter of 2014 in value terms) due to the combined effect of devaluation, weak domestic demand and a lower price of gas imports during the first quarter.

Figure 1:
Growth stagnated…

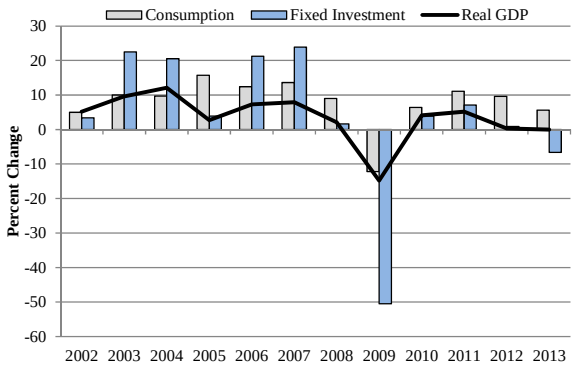


Figure 2:
…and was below regional peers...

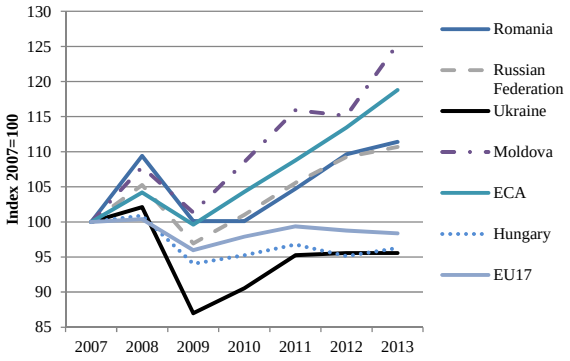


Figure 3:
…with growing twin deficits…

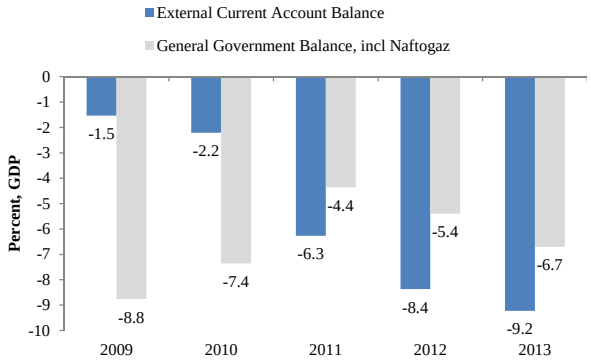
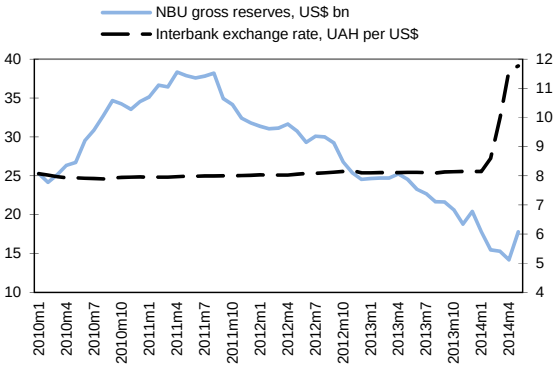


Figure 4:
…which put pressure on foreign reserves



Source: National authorities, World Bank staff calculations.

13. **Despite the adjustment in the current account, balance of payment pressures remain acute due to large external debt refinancing needs, low FDI and limited access to external financing.** The rollover rate for external debt (corporate and bank sector) fell during the first two months of the year but has recovered since then, averaging 106 percent during the first five months of 2014. While investor sentiment improved after the approval of the IMF SBA and the Presidential elections, it remains cautious, with Ukraine's 5 year sovereign credit default swap spreads trading at around 750 basis points in mid-July 2014 (down from around 1200 basis points in early-May 2014). Net FDI inflows turned negative over Jan-May (-US$1 billion) because of continuing political uncertainty. Official inflows, including the first tranche of the IMF SBA (US$3.09 billion) and the World Bank First Development Policy Loan (US$750 million) in May, helped ease balance of payments pressures. Foreign exchange reserves have stabilized but remain low at around 2.5 months of import cover by end June (Figure 4).

Table 1: Key Macroeconomic Indicators

	2011	2012	2013	2014e	2015f	2016f	2017f
Real economy							
Nominal GDP, UAH *billion*	1302.1	1411.2	1454.9	1525.0	1757.4	1969.9	2202.3
Real GDP, *percent change*	5.2	0.3	0.0	-6.5	1.0	4.0	4.0
Per Capita GDP, *US$ Atlas Method*	3140	3640	3960	…	…	…	…
Contributions:							
Consumption percent points of GDP	*9.4*	*8.2*	*5.2*	…	…	…	…
Investment percent points of GDP	*3.2*	*-2.6*	*-4.2*	…	…	…	…
Net exports percent points of GDP	*-7.4*	*-5.3*	*-1.0*	…	…	…	…
Consumption, *percent volume change*	11.1	9.6	5.6	-5.9	0.2	4.3	4.5
Investment, *percent volume change*	7.1	0.9	-6.6	-31.1	-2.0	6.7	7.1
Exports, *percent volume change*	4.3	-7.7	-8.8	-7.4	3.5	3.6	4.1
Imports, *percent volume change*	17.3	1.9	-5.9	-21.6	3.2	3.8	5.9
Unemployment rate (ILO definition), *percent*	7.9	7.5	7.5	9.6	9.5	9.0	8.0
GDP deflator, *percent change*	14.3	8.1	3.1	12.1	14.1	8.3	7.5
CPI (pa), *percent change*	8.0	0.6	-0.3	11.4	14.0	7.0	6.1
CPI (eop), *percent change*	4.6	-0.2	0.5	19.0	9.0	6.9	5.8
Fiscal Accounts							
Expenditures, *percent GDP*	45.7	48.9	48.4	48.1	46.4	45.3	45.1
Revenues, *percent GDP*	42.9	44.5	43.6	42.3	42.5	42.5	42.6
General Government Balance, *percent GDP*	-2.8	-4.4	-4.8	-5.8	-3.9	-2.8	-2.5
PPG debt (eop), *percent GDP*	36.3	36.6	40.6	67.4	73.2	70.6	66.1
Selected Monetary Accounts							
Base Money, *percent change*	6.3	6.4	20.3	27.7	19.7	16.6	13.7
Credit to non-government, *percent change*	9.5	2.2	11.8	10.2	6.9	7.8	10.8
Interbank overnight rate (annual average), *percent*	5.8	10.8	3.8	…	…	…	…
Balance of Payments							
Current Account Balance, *percent GDP*	-6.3	-8.1	-9.2	-2.5	-2.5	-2.7	-3.1
Exports, *percent GDP*	54.6	51.0	48.1	58.1	59.5	56.3	53.8
Imports, *percent GDP*	60.8	59.3	56.8	59.1	60.7	57.9	56.5
Foreign Direct Investment, *percent GDP*	4.3	3.8	1.8	0.1	1.3	1.1	1.5
Gross Reserves, *billion US$, eop*	31.8	24.5	20.4	16.2	23.3	29.7	32.6
In months of next year's imports	*3.7*	*2.9*	*2.8*	*2.4*	*3.2*	*3.9*	*4.1*
Percent of short-term external debt	*55.4*	*38.1*	*30.3*	*29.4*	*48.5*	*56.9*	*55.4*
External Debt, *percent GDP*	77.6	76.6	78.6	103.0	110.2	105.6	98.8
Terms of Trade, *percent change*	7.2	5.7	0.9	-1.6	-0.7	-0.6	-0.4
Exchange Rate, UAH/*US$ (average)*	8.0	8.0	8.2	…	…	…	…
Memo:							
Nominal GDP, *US$ billion*	162.8	176.4	177.4				

Source: National authorities, IMF, and World Bank staff calculations.

14. **The economic contraction and the situation in the east are putting pressure on fiscal accounts.** Ukraine entered the current crisis with a large fiscal deficit of 6.7 percent of GDP in 2013 – including the deficit of the state energy company, Naftogaz. Fiscal imbalances were exacerbated by weak revenue performance, delayed tariff hikes in the gas and district heating sectors, and increases in wages and pensions. To contain the budget deficit during 2014, the Government adopted a package of fiscal adjustment measures in March 2014 that bolster revenues (1.2 percent of GDP) while curtailing expenditures (-2.0 percent of GDP), compared to

the originally adopted 2014 Budget[2]. Revenue performance during the first quarter was mixed, with a decline in corporate income taxes (-11.5 percent, y/y) and stagnating personal income tax receipts which were offset by slight increases in VAT (3.3 percent, y/y), other taxes (2.5 percent, y/y) and frontloaded profit transfers from the NBU (64 percent, y/y)[3]. At the same time, the ongoing conflict in the East is adding to security-related expenditure pressures. To offset these impacts the Government adopted additional measures to curtail other discretionary expenditures, including both expenditure on investment and goods and services.

15. **Following a period of price stability, inflation is accelerating fuelled by utility tariff increases and currency devaluation.** Despite the economic slowdown, consumer price inflation has accelerated markedly to 12.0 percent (y/y) in June – the highest annual increase since late 2011. To contain inflationary pressures, NBU increased its key policy rate from 9.5 to 12.5 percent in mid-July while the average weighted rate for NBU refinancing rose to 17.5 percent. Meanwhile, national currency deposit and lending rates remain in double-digits at 12.6 and 17.6 percent, respectively. High interest rates are dampening credit to the economy, which declined by 9 percent y/y in real terms during the first quarter.

2.2 MACROECONOMIC OUTLOOK AND DEBT SUSTAINABILITY

16. **The macroeconomic framework underpinning this operation is aligned with the IMF SBA and takes into account outcomes of the first quarter of 2014.** The baseline scenario reflects the impact of the macroeconomic adjustment anchored in the IMF SBA, slower growth in key trading partners, higher gas import prices announced in March 2014, as well as disruption of economic activity in eastern Ukraine. While risks remain high, initial data on the real sector, external, fiscal and price dynamics are broadly in line with the projections for 2014.

17. **Real GDP is expected to decline by 6.5 percent in 2014 in the baseline scenario before recovering to 1 percent in 2015.** While output decline during the first quarter was relatively shallow, we expect economic contraction to continue to deepen over the coming months as a result of the ongoing macroeconomic adjustment and protracted instability in the industrialized east. In particular, we expect that tighter fiscal and monetary policies – underpinning the necessary adjustment – will be contractionary in the short term and negatively affect purchasing power of households and businesses. Credit to the economy is expected to contract in real terms during 2014 as a result of tighter liquidity and lending standards. Therefore, both consumption and fixed investment are expected to decline in 2014. While external demand from Ukraine's largest trade partners is likely to be muted, net exports are projected to positively contribute to growth, as imports are expected to continue contracting more due to depreciation. From 2015 onwards, a moderate recovery is expected driven by

[2] The main revenue measures include: i) VAT base broadening through cancellation of zero VAT rate application for grain and industrial crop exports and introduction of 7 percent VAT rate for Pharmaceuticals (0.4 percent of GDP) and ii) Excise rate increases and indexation of land prices (0.3 percent of GDP), iii) improved tax and customs administration (0.4 percent of GDP) and iv) increased fees on use of mineral resources (0.1 percent of GDP). The main expenditure measures include: i) public sector wage freeze in 2014 (0.5 percent of GDP) ii) changes in indexation of pension benefits in 2014 (0.2 percent of GDP), iii) rationalization of subsidies to enterprises (0.1 percent of GDP), iv) curtailment of capital expenditures (0.5 percent of GDP) and v) other expenditure measures (0.7 percent of GDP).

[3] The first quarter transfer of NBU transfer amounted to UAH 22 Billon, equal to the budgeted annual transfer to the budget. No further transfers are expected during the remainder of the year.

growing net exports and – to a lesser extent recovery in consumption. Starting from 2016, investment is projected to rebound after four consecutive years of decline, contributing positively to economic growth. Credit growth is expected to recover moderately in 2016, provided problems in the banking sector are resolved. The macroeconomic adjustment and accelerated structural reforms, including improved investment climate are expected to boost competiveness and productivity of Ukraine's businesses – a precondition for a return of economic growth and a sustainable recovery.

18. **Inflation is expected to pick up during 2014 before decelerating in the outer years of the projection period with the NBU moving to targeting inflation in line with the IMF recommendation.** In 2014, inflation is projected to be high (19 percent y/y, end of period) due to utility tariff increases and currency depreciation. Given the expected move towards inflation targeting, it is projected to decelerate over the medium term to around 5.8 percent by 2017.

19. **The current account deficit will narrow in 2014-2015 due to the substantial decline in domestic demand engendered by exchange rate adjustment and fiscal consolidation.** While the potential positive impact of depreciation on exports will initially be limited due to sluggish external demand, imports are expected to contract significantly. Therefore, current account deficit is projected to decline to 2.5 percent of GDP in 2014 but to widen slightly to 3.1 percent by 2017 driven by the recovery in growth.

Table 2: Balance of Payment Financing Requirements and Sources

	2013	2014e	2015f	2016f	2017f
Financing requirements (US$ billion)	**66.4**	**59.8**	**49.1**	**49.2**	**53.2**
Current account deficit	16.3	3.2	3.4	4.0	5.1
Long-term debt amortization (excl. IMF)	18.0	18.0	12.0	12.1	13.2
Short-term debt amortizations	34.0	37.0	32.8	33.1	34.8
Other short-term capital outflows	-1.9	1.6	0.9	0.0	0.0
Financing Sources (US$ billion)	**66.4**	**59.8**	**49.1**	**49.2**	**53.2**
FDI and portfolio investments (net)	11.9	2.0	0.5	3.2	4.0
Long-term debt disbursements (excl. IMF)	19.0	17.2	15.5	16.6	18.2
Short-term debt disbursements	37.0	32.8	33.1	34.8	35.8
Change in reserves	4.1	4.2	-7.1	-6.4	-2.9
IMF credit (net)	-5.6	3.7	7.1	1.0	-1.9

Source: National authorities and World Bank staff calculations.

20. **Despite the narrower current account deficit, balance of payment financing needs continue to be significant due to persistent pressures in the financial account (Table 2).** Due to heightened regional tensions and uncertainty about possible Parliamentary elections in the fall, FDI is expected to remain subdued in 2014 and to recover slowly from 2015 onwards as political and economic conditions improve. Aggregate rollover rate of external debt (excluding IMF) is assumed to drop to 89 percent (down from 107 percent in 2013, when access to external financing was already affected by growing economic challenges). While the maturity structure of corporate external debt is heavily weighted on the short term (around 40 percent), a large portion is for trade credits, thus limiting rollover risks. Nevertheless, corporate rollover rates are expected to drop to 85 percent. For external debt of the banking sector, rollover rates of 88 percent are projected due to continued deleveraging, especially of foreign-owned banks. Net outflows in the banking and corporate sector will be offset by inflows of large official assistance.

Under the base case, therefore, available external financing is expected to be sufficient to meet balance of payments requirements. However, high external debt refinancing needs may not allow NBU to rebuild reserves in 2014. Going forward, macroeconomic stabilization supported by the IMF SBA is expected to boost investor confidence and lower costs of external financing. From 2015 onwards, a gradual buildup of international reserves to 4.1 months of imports cover is expected by 2017 (Table 1).

Table 3: Key Fiscal Indicators, Percent of GDP

	2011	2012	2013	2014e	2015f	2016f	2017f
General Government Balance	-2.8	-4.4	-4.8	-5.8	-3.9	-2.8	-2.5
Total Revenues	**42.9**	**44.5**	**43.6**	**42.3**	**42.5**	**42.5**	**42.6**
Tax revenues	38.4	38.9	37.9	37.3	37.5	37.6	37.7
Corporate profit tax	4.2	4.0	3.8	2.7	2.7	2.8	2.8
Personal Income tax	4.6	4.8	5.0	4.8	4.8	4.7	4.7
Payroll tax	12.4	13.0	13.3	12.3	12.3	12.1	12.1
Property tax	0.8	0.9	0.9	0.7	0.7	0.7	0.7
VAT	10.0	9.8	8.8	9.5	9.5	9.6	9.6
Excises	2.6	2.7	2.5	2.9	3.0	3.3	3.4
Taxes on international trade	0.9	0.9	0.9	1.0	1.0	1.0	1.0
Other tax	2.9	2.8	2.7	3.4	3.5	3.4	3.4
Non-tax revenues	4.5	5.6	5.7	5.0	5.0	4.9	4.9
Expenditures (economic cl.)	**45.7**	**48.9**	**48.4**	**48.1**	**46.4**	**45.3**	**45.1**
Current expenditures	**42.3**	**45.7**	**46.2**	**45.3**	**43.8**	**42.3**	**42.1**
Wages and compensation	10.4	11.2	11.5	11.1	10.2	9.3	9.3
Goods and services	6.8	7.4	7.1	6.7	6.2	5.7	5.7
Interest payments	2.0	1.9	2.5	3.4	4.5	5.1	5.1
Subsidies to corporations	1.9	3.1	2.0	2.0	1.9	1.9	1.9
Current transfers	21.2	22.1	23.1	22.1	21.0	20.3	20.1
Pensions	16.2	16.6	17.2	16.3	15.2	14.6	14.5
Unemployment, disability and accident insurance	1.8	1.6	2.0	1.8	1.8	1.7	1.6
Social programs	3.2	3.9	3.9	4.0	4.0	4.0	4.0
Other current expenditures	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Capital expenditures	3.0	2.9	2.0	1.3	1.9	2.2	2.3
Reserve fund	0.0	0.0	0.0	1.2	0.6	0.6	0.6
Net lending	0.4	0.3	0.2	0.3	0.1	0.2	0.1
General Government Financing	**2.8**	**4.3**	**4.8**	**5.8**	**3.9**	**2.8**	**2.5**
External (net)	1.2	2.0	1.3	4.1	-0.4	2.9	0.6
Domestic (net)	2.4	2.4	3.5	1.6	4.3	-0.2	1.7
of which: privatization	1.8	0.9	0.1	0.1	0.8	0.7	0.6
Naftogaz deficit	**1.6**	**1.1**	**1.9**	**4.3**	**1.9**	**1.1**	**0.7**
Government financing of Naftogaz deficit	0.5	0.5	1.4	7.6	2.1	1.0	0.5
Other Naftogaz financing (including accumulation of arrears)	1.1	0.6	0.5	-3.2	-0.2	0.1	0.2
VAT bonds	0.0	0.0	0.0	0.5	0.0	0.0	0.0
Bank Recapitalization Requirements and DGF	0.7	0.0	0.1	1.3	1.3	0.0	0.0
Total financing	**5.1**	**6.6**	**6.7**	**11.9**	**7.1**	**3.9**	**3.2**

Source: National authorities, IMF, and World Bank staff calculations.
Note: Fiscal projections (both revenue and expenditure) from 2014 onwards exclude Crimea.

21. **Fiscal deficit is expected to decline gradually over the next three years.** In the base case, the Government is expected to implement a fiscal consolidation anchored in the IMF SBA. Despite risks associated with the economic slowdown, general Government deficit is projected to be 5.8 percent of GDP and 10.1 percent of GDP in 2014 including the Naftogaz deficit of 4.3 percent of GDP[4]. While the recession is expected to dampen revenue collection, especially of direct taxes (Corporate Income Tax, Personal Income Tax, and Payroll Taxes), devaluation and

[4] Increases in residential gas tariffs will reduce the Naftogaz deficit. Despite tariff increases, Naftogaz deficit is expected to increase in 2014 because of escalating cost of gas due to depreciation.

inflation will bolster nominal collections of VAT, excises and customs duties, therefore containing overall revenue shortfalls in 2014. In addition, tax policy changes, adopted in March 2014, and improved tax administration, including steps to curb wide spread tax evasion are expected to shore up revenue collection despite the economic downturn. Starting from 2014, the Government is expected to rationalize expenditures in line with World Bank and IMF recommendations mainly by lowering public consumption and current transfers. Nominal public sector wage and pension freezes which are expected to remain in place for the coming years would reduce payroll and pension spending, especially in the context of accelerating inflation. As a result, general Government deficit is expected to narrow to 2.5 percent by 2017. Further scheduled annual increases in gas and district heating tariffs are expected to gradually reduce losses of Naftogaz (Table 3).

22. **The Debt Sustainability Analysis (DSA) indicates that public and external debt remain sustainable in the base case, but are subject to high risks.** In the base case, public debt (see Table 1) rapidly increases to 67.4 percent of GDP in 2014, driven by large financing needs and substantial real depreciation of Hryvnia. It is projected to peak at 73.2 percent of GDP in 2015, but will then steadily decline. Risks to the base case are high, especially from lower growth, real exchange rate depreciation, and contingent liability shocks. A growth shock, with a cumulative growth decline of 9 percent in 2015-2016, would result in the debt-to-GDP ratio of 96 percent in 2016. (Figure 5). In the base case, total external debt peaks above 100 percent of GDP in 2014-2016 due to real depreciation and then steadily declines as exchange rate misalignment disappears and current account deficit is reduced. A growth shock in 2015-16 would keep external debt above the 100 percent threshold in the medium term. A real depreciation shock would drive debt to some 120 percent of GDP before retreating back to a 100 percent (Figure 6).

Figure 5:
Public and Publicly Guaranteed Debt Dynamics
(percent of GDP)

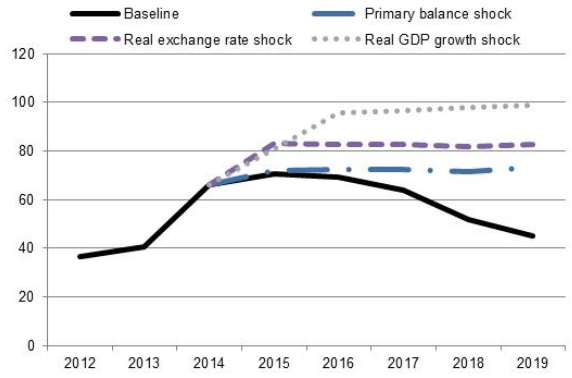
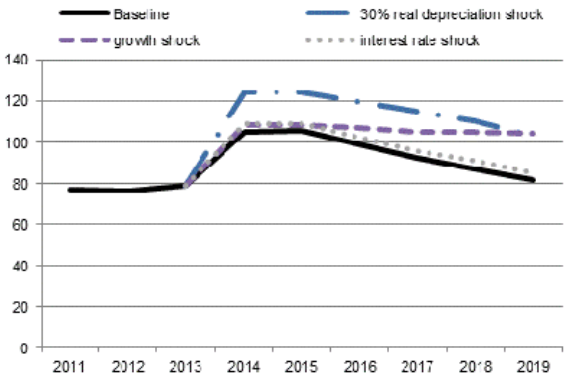


Figure 6:
External Debt Dynamics
(percent of GDP)



Source: IMF, 2014.

23. **Risks to the macroeconomic outlook are high.** *First*, a deeper than expected recession during 2014 and a slower recovery during 2015 could make the adjustment more challenging. A prolonged confrontation in the heavily industrialized eastern part of Ukraine could negatively affect growth. Lower levels of bank liquidity, especially in the context of significant risks in the

banking sector and monetary tightening, could constrain credit supply, in turn delaying the expected pick up of domestic investment while foreign investment may remain subdued due to heightened political uncertainty. Meanwhile, the recovery in consumption could be undermined by the combined effect of fiscal adjustment and depreciation. *Second*, external liquidity constraints could emerge if financing needs rise above those projected in the baseline or if rollover rates drop more due to tighter financial conditions in global markets and/or heightened risk perception. Shortfalls in official financing due to slippages in implementing macroeconomic and structural reforms could potentially reduce external support and complicate efforts to finance current account and fiscal deficits. *Third*, weaker growth of key trade partners could undermine the recovery of exports, dampening growth and adjustment of the current account. *Fourth*, geopolitical tensions and disputes over gas prices could lead to a prolonged disruption in gas supply[5] as well as possible restrictions on exports to the Russian Federation reducing growth and leading to larger than expected external imbalances. *Fifth*, efforts to restore sustainable public finances could prove to be more challenging than expected. The economic downturn and compliance problems in the east may undermine revenue performance despite policy changes and efforts to improve tax administration. On the expenditure side, cuts, especially of social spending, could run into resistance and kindle further unrest.

24. **Macro-financial links may exacerbate these risks.** A lesson learnt from past financial crises, including the 2008 crisis in Ukraine, is that macro-financial links can create vicious circles between initial macroeconomic shocks, balance sheet problems in banks, instability and liquidity in financial markets which in turn deepen the economic downturn and may impose a fiscal burden on the budget. The current macroeconomic crisis has already aggravated risks in the banking sector (See section 2.3). Currency depreciation is putting pressure on banks' capital through losses generated from open short foreign exchange positions[6] and increase in non-performing loans which are already high[7]. The deterioration in capital adequacy in turn is likely to force banks to make adjustments in their lending standards. An ensuing credit crunch would further weaken investment and spending amplifying the economic downturn. Concurrently, the fiscal financing necessary to bolster confidence in the banking system would add to fiscal imbalances and sovereign debt which are already significant – imposing additional challenges for the macroeconomic adjustment.

2.3 RECENT BANKING SECTOR DEVELOPMENTS

25. **Banks dominate Ukraine's financial sector, with about 95 percent of total financial**

[5] After several attempts to resolve the dispute over gas prices, Gazprom suspended gas supplies to Ukraine on June 16 2014. While fuelling uncertainty, the immediate economic impact is expected to be limited. Ukraine's gas reserves stand at about 13 bcm, equal to about 2-4 months of imports. If the supply disruption would last for an extended period it will affect industrial production (steel, fertilizer) as well as power generation (46 percent of Ukraine's generation capacity depends on hydrocarbons, including gas) and therefore the economy at large.

[6] In February 2009, at the peak of Ukrainian banking crisis, the NBU adopted Resolution 109 changing the rules for calculating open currency positions. The move was aimed to increase supply of foreign currency as provisions for foreign exchange denominated loans were excluded from calculations of open currency positions. As a result, banks started to accumulate short open currency positions under international accounting rules. Repeal of Resolution 109 -a prior action under the IMF SBA- will add to pressure on the exchange rate as banks try to buy foreign exchange to balance their open currency positions.

[7] Non-performing loans account for approximately 12.9 percent of the total loan portfolio using the narrow definition (share of loans classified as doubtful and loss in total loans) and 23.5 percent using the broad definition (share of loans classified as substandard, doubtful and loss).

sector assets. The banking sector can be divided into four distinct subgroups by ownership: local private banks (52 percent of assets); local state-owned banks (19 percent); foreign private banks comprised mainly of European banking groups (20 percent); and foreign state-owned banks that are all Russian owned (9 percent). The banking system is characterized by a relatively low degree of concentration, with 181 banks operating in the market and the top three banks accounting for a relatively low 31 percent of the market based on assets as of end-2013. Many of the smaller banks are "pocket banks", established to provide banking and treasury operations to related companies, mainly large industrial-financial conglomerates.

26. **The banking sector was hard hit by the global financial crisis that began in 2008.** The banking sector grew very rapidly between 2005 and 2008, with total loans increasing by 729 percent from end-2004 to end-2008 and credit to GDP peaking at 83.4 percent in 2008. The growth in credit was fueled by external borrowing and much of this lending was denominated in FX to unhedged borrowers. The sharp economic decline that occurred in 2008-2009 hit the banking sector particularly hard. UAH retail deposits declined by 23 percent from September 2008 to April 2009 due to concerns about the health of the banking sector and currency depreciation. As NPLs increased, the regulator, with extensive financial and technical support under World Bank and IMF programs, required a number of vulnerable banks to prepare and implement time-bound restructuring and recapitalization plans. While most private owners were able to bring in the required capital, 15 banks went into insolvency, and three institutions were recapitalized by the state at the cost of about 2.7 percent of 2009 GDP. Although confidence of depositors was restored by 2010, the authorities did not follow through with longer-term structural and institutional reforms needed to address deep-seated banking sector vulnerabilities such as high level of NPLs, weak corporate governance in some banks, the high share of related party lending, and issues inhibiting the effectiveness of banking supervision.

27. **Slow economic growth and incomplete structural reforms have weighed on the banks that operate in Ukraine.** The need to provision for non-performing assets caused losses in the banking sector from 2009-2011. Although broadly defined NPLs (Categories III, IV, and V) have declined from their peak of 40.3 percent of total loans in 2010, they remained high at 23.5 percent at end-2013. Credit growth remained lower than during the period preceding the 2008-09 crisis, partially due to restrictions on FX lending to unhedged borrowers and an increase in public sector borrowing that crowded out private lending. The NBU's monetary policy aimed at defending the currency peg at any cost also decreased liquidity and pushed up interest rates. There was deleveraging following the 2008-09 crisis, with the loan-to-GDP ratio declining from 83.4% at end-2008 to 57.8% at end-2012, with a slight recovery in 2013. Meanwhile, deposits have grown as a result of the high interest rate environment, with a 20.0 percent growth in total deposits in 2013. The sector showed modest profitability in 2012 (ROE of 3 percent) and 2013 (ROE of 0.8 percent), but in the first four months of 2014 losses amounted to UAH 4.5 billion loss (implying an annualized ROE of -7.2 percent). The difficult operating environment and regional deleveraging have caused a number of foreign banks (Commerzbank, Swedbank, SEB, Erste, the Bank of Cyprus and Intesa Sanpaolo) to exit the Ukrainian market over the past two years. As a result, the foreign owned share in aggregate statutory capital of banking system has declined from 41 percent in 2010 to 34 percent by end 2013.

Table 4: Key Banking Sector Indicators 2007-2014

	2007	2008	2009	2010	2011	2012	2013	1Q2014**
Assets/GDP	84.1%	97.5%	96.4%	86.1%	81.0%	80.0%	87.8%	89.7%
Loans/GDP	68.1%	83.4%	81.8%	69.0%	63.4%	57.9%	62.6%	68.8%
Customer deposits / GDP ***	38.9%	37.7%	35.8%	38.1%	37.3%	40.6%	46.5%	44.4%
Loans/Deposits ***	1.52	2.05	2.19	1.75	1.63	1.43	1.35	1.49
Share of FX loans ***	49.9%	59.1%	51.3%	46.6%	40.7%	37.0%	34.0%	41.8%
Share of FX deposits ***	32.1%	44.0%	47.0%	42.0%	42.4%	43.7%	36.8%	43.3%
NPLs*/total loans		3.9%	13.7%	15.3%	14.7%	16.5%	12.9%	13.3%
ROA	1.5%	1.0%	-4.4%	-1.5%	-0.8%	0.5%	0.1%	-0.6%
ROE	12.7%	8.5%	-32.5%	-10.2%	-5.3%	3.0%	0.8%	-4.2%
CAR	13.9%	14.0%	18.1%	20.8%	18.9%	18.1%	18.3%	14.8%

* Loans of IV and V categories under NBU classification; NPLs including Category III are at ~24 percent. Dec 2012 change in NBU's loan classification methodology resulted in series break.
** The World Bank forecast of 2014 nominal GDP is used for calculating 1Q2014 ratios with nominal GDP in denominator. Return on Assets (ROA) and Return on Equity (ROE) are annualized figures, extrapolated from actual 1Q2014 results.
*** based on monetary statistics.
Source: NBU

28. **Since the beginning of 2014, banking sector liquidity has been hard hit by the combination of political and exchange rate pressures** (Table 4)**.** Depreciation of the local currency during January-April 2014 following the abandonment of the long standing peg to the dollar as well as exogenous risks caused by political turmoil and security concerns have put the trust in the banking system to a serious test. As a result of these pressures 12.6 percent of UAH and 26.1 percent of FX denominated retail deposits left the banking system in the first six months of 2014. It should be noted that most of the deposits left the system from late February to end March 2014, and the outflow in April-June was largely confined to two regions in eastern Ukraine where military operations are being conducted. The NBU has relied on a range of liquidity support instruments -- disbursing UAH 104.8 billion in the first five months of 2014 -- in an effort to support banks suffering deposit outflows. While the NBU's actions have helped maintain adequate liquidity in the system for now, the risk of further deposit outflows and even bank runs is significant given the volatile political and security situation.

29. **The currency depreciation and worsening economic outlook is likely to lead to a gradual erosion of banks' capital positions.** The recent currency depreciation is putting an immediate strain on the banks' capital adequacy ratio through proportionate losses generated from the still sizable open short FX position[8] (about US$3.6 billion at end-2013). As a result, the banking system's overall Capital Adequacy Ratio (CAR) declined from 18.3 percent to 15.2 percent between end-December 2013 and end-May 2014, according to official statistics. The longer-term negative impact of currency depreciation, coupled with general worsening economic outlook, is likely to result in asset quality deterioration, particularly in the remaining relatively large share of FX-denominated loans (34 percent of the total loan portfolio at end 2013). Past experience shows that the quality of servicing these loans will decline with a 3-6 months lag,

[8] In February 2009, the NBU adopted Resolution 109 changing the rules for calculating open currency positions. The move was aimed at increasing the supply of foreign currency as provisions for FX denominated loans were excluded from calculations of open currency positions. However, by reducing FX assets to comply with the local regulatory open currency position limit, banks de-facto started to accumulate short open currency positions under international accounting rules. The step-by-step repeal of Resolution 109 agreed under the current IMF Program will gradually bring the calculation of open foreign currency positions in line with international accounting rules.

with the resulting negative impact on the banks' capital. Finally, geopolitical tensions can result in further losses for Ukrainian banks, as shown by the current difficulties with banking operations in the eastern regions of Ukraine and Crimea[9].

30. **Meanwhile, the capacity of the bank resolution system is already strained.** Eleven banks[10] have been declared insolvent by the NBU and transferred for resolution to the DGF in the first six months of 2014. The payout of insured deposits[11] in these banks is likely to deplete DGF's accumulated reserves, which stood at UAH 6.8 billion at the beginning of June. As liquidity and capital pressures accumulate, a number of additional banks may be declared insolvent in the coming months, thus putting an additional burden on the DGF's operational, and particularly, financial capacity. Unless back-up funding is provided by the GoU, the current stock of DGF's premium reserves and the expected quarterly inflows are not likely to be sufficient to meet the greatly increased depositor payout or resolution funding needs in the coming months.

2.4 IMF RELATIONS

31. **At the request of the authorities, the IMF prepared a two-year SBA in the amount of US$17.1 billion (SDR 10.976 billion) that was approved by the IMF Board on April 30, 2014.** The Program supported by the IMF aims to stabilize the economy and create the necessary conditions to spur growth, and focuses on the following areas: monetary and exchange rate policies; the financial sector; fiscal policies; the energy sector; and governance, transparency and the business climate. The World Bank team has collaborated closely with the IMF team in areas where it has long-standing engagements with the authorities, including financial sector reform.

32. **The World Bank and IMF teams are coordinating closely on the design and implementation of financial sector reforms supported by, respectively, this FSDPL series and the IMF's SBA, to ensure consistency of policy messages and avoid duplication of efforts.** In particular, the World Bank and IMF teams are jointly advising the authorities on the external diagnostic assessments of Ukrainian banks, and have complementary conditionality on this subject. There is also close ongoing coordination on broader structural reforms supported by the Fiscal Adjustment and Institutional Reform DPL series.

3. THE GOVERNMENT'S PROGRAM

33. **The authorities are committed to a prioritized reform program aimed at stabilizing the banking system and resuming sustainable financial intermediation.** Given the current political and macroeconomic pressures, the immediate objective for the next three to six months is to restore and maintain public confidence and preserve the stability of the banking sector. Simultaneously, the recently appointed management of the NBU is pursuing supervisory and

[9] Crimea accounts for around 2 percent of total banking system loans and deposits.
[10] The eleven banks are: Daniel, Real, Mercury, Interbank, Promeconom, Avtokraz, Zakhidinkom, Pivdenkom, Starokyivskiy, Brokbusiness, and Forum (the latter two in the top 30 banks by assets)
[11] DGF provides retail deposit coverage of UAH 200,000 per depositor per bank. Currently, this covers >99.5 percent of retail deposit accounts, and ~58 percent of the total volume of retail deposits.

regulatory actions that should result in a more consolidated and resilient banking sector, and restart the flow of credit to the real sector in the medium run.

34. **The authorities' banking sector stabilization and restructuring program focuses on five areas:** (i) maintaining adequate liquidity via NBU instruments; (ii) conducting independent diagnostic studies of large and medium-sized banks to determine their financial condition; (iii) enforcing recapitalization /restructuring of banks that have capital shortfalls or other deficiencies based on the diagnostic studies; (iv) undertaking resolution of unviable banks through a properly resourced DGF; and (v) strengthening the legal and supervisory framework to make the sector more resilient to future shocks. Although the program has not been recorded in a single policy document, its various elements have been articulated in decisions and regulations issued by the NBU, DGF, and Ministry of Finance (MoF), and are presented in the Letter of Development Policy attached to this document (Annex 2).

35. **Liquidity management, bank diagnostics, bank recapitalization or resolution, and enhancement of the supervisory framework are the key pillars of any comprehensive crisis response.** The authorities' banking sector stabilization and restructuring program also draws extensively on Ukraine's experience during the 2008-2009 financial crisis. To ensure that the banking sector has enough liquidity to function, the NBU has already expanded the range and volume of liquidity instruments, and sought to improve the transparency of its decision-making process.[12] To maintain depositor confidence, the government is also making sure that the DGF has the financial, operational and technical capacity to handle any insolvent banks in a timely and orderly fashion. Since the capital adequacy of many banks is expected to be significantly impaired by the currency depreciation and economic crisis, the NBU has launched an external diagnostic exercise of large and medium-sized banks to assess the extent of the likely undercapitalization. Following the determination of the extent of capital impairment, the banks will need to be recapitalized with private resources or, when this is not feasible, be resolved by the DGF using least cost solutions. In a few cases of large banks that are too big to fail, the Government may need to step in with budget resources for recapitalization[13]. Finally, the legal and supervisory framework (including enforcement) is being strengthened with the aim to promote sector consolidation, deal with structural problems such as NPLs and related party lending, and make the system better prepared to withstand possible future shocks.

36. **The authorities are also preparing a longer-term strategy for the Ukrainian financial sector.** The work is being coordinated by the NBU's newly established Strategy Department, with active participation from financial institutions operating in Ukraine and International Financial Institutions (IFIs). The strategy will set the goals and policy priorities for financial sector development until 2020, with particular attention given to the following issues: (i) adaptation to EU standards; (ii) improving corporate governance; (iii) improving banking supervision; (iv) development of non-bank financial institutions (NBFIs); and (v) improving financial infrastructure. The strategy document is expected to be completed and adopted by the

[12] Open access to weekly refinancing tenders was introduced for all banks. Long-term liquidity instruments were linked to deposit outflow levels and can be collateralized with banks' loan portfolios, with substantial discount. To stimulate timely repayment of loan-collateralized and stabilization loans, penalty interest rates (three times the NBU refinancing rate) were applied.

[13] The revised 2014 budget includes a below-the-line allocation for potential state participation in bank recapitalization, in the amount of UAH 15 billion (around 1% of GDP).

NBU Board by end-August 2014, and will provide an important policy anchor for preparation of FSDPL2 and World Bank Group's future work in financial sector in Ukraine.

4. THE PROPOSED OPERATION

4.1 LINK TO GOVERNMENT PROGRAM AND OPERATION DESCRIPTION

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

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

39. **The design of the programmatic series builds on the lessons from the 2008-09 financial crisis and long-standing policy dialogue with authorities.** One of the most important lessons from the 2008-09 crisis in Ukraine is the need to have a strong, fully resourced entity in charge of bank resolution and insured deposit payout. Another key lesson is that the recapitalization program should be based on external diagnostic assessments, while the use of state funds should be subject to clear and transparent bank eligibility and governance criteria. Although FSDPL1 was prepared on an accelerated basis due to the current crisis, the design of the operation builds on the significant analytical work that has been done by the World Bank in recent years. This policy dialogue was sustained through technical assistance (TA) based on a programmatic financial sector TA program. The design of the prior actions and triggers is based on the findings of this TA (Table 5).

4.2 PRIOR ACTIONS, RESULTS AND ANALYTICAL UNDERPINNINGS

Pillar 1: Strengthening the operational, financial and regulatory capacity of the DGF for the resolution of insolvent banks

40. **The DGF is a core part of the financial safety net and plays a critical role in maintaining the confidence of depositors**. One of the important financial sector reforms implemented in the aftermath of the 2008-2009 financial crisis was the increase in the deposit insurance coverage limit and the transformation of the DGF from a pure deposit insurance and payout entity to a bank resolution entity. A new DGF Law was enacted in February 2012, and became effective in September 2012. Before the onset of the current crisis, the DGF managed the provisional administration and resolution planning of two relatively small insolvent banks, which are now under liquidation.

41. **Pillar 1 aims to urgently strengthen the DGF to ensure that it can perform its bank resolution and deposit payout functions effectively in the current crisis environment.** The workload of the DGF has increased dramatically in recent months as eleven banks -- including two medium-sized ones -- have been declared insolvent and transferred for resolution to the DGF since the beginning of the year. Given the stress caused by the currency depreciation, a significant number of additional banks could be heading to the DGF for resolution in the coming months.

Prior Action 1: The Borrower has strengthened DGF's financial capacity by establishing a mechanism for long-term back-up funding from the Borrower, through enactment[14] of the Law "On Amendments to the State Budget Law of Ukraine of Year 2014", and adoption of the Cabinet of Ministers resolution.

42. **The financial resources of the DGF will be strained in case of additional bank failures.** The main source of DGF funding is the premiums collected from banks. The current assets of the DGF and the expected quarterly premium inflows are not likely to be sufficient to meet the insured depositor payout or resolution funding needs in the coming months. The assets of the DGF as of the beginning of June, 2014 were UAH 6.8 billion, which was close to the estimated maximum payout of insured deposits for the eleven insolvent banks that were put under temporary administration by the DGF since the beginning of 2014. Since the DGF's level of financial resources is public information, its significant depletion or failure to comply with standard payout deadlines could lead to panic among depositors, withdrawal of deposits, and a further loss of confidence in the banking system.

43. **It is therefore imperative for the DGF to urgently obtain back-up funding from the GoU in line with the projected needs.** Under the provisions of the DGF Law, additional funding can be obtained in three ways: (i) collection by the DGF of extraordinary deposit insurance premiums from its member banks; (ii) short-term (not more than one year) liquidity credit from the NBU to meet urgent payout needs; and (iii) long-term loans or grants from the state budget. Considering that the levying of extraordinary deposit insurance premiums on banks is highly risky during this period of stress and that the NBU's liquidity support is limited by term, size and collateral requirements, the bulk of DGF's back-up funding must come from the State. The DGF's most recent funding needs analysis suggests that the DGF could require between UAH 5.3 billion (baseline scenario) and 10.13 billion (about 0.7 percent of GDP) in back-up funding during the remainder of this calendar year to maintain the required statutory

[14] Enactment means legislation is approved by Parliament, signed by the President, and published in official gazette.

minimum level of reserves of 2.5 percent of total insured deposits.

44. **This prior action supports the creation of a back-up funding mechanism for the DGF.** Amendments to two laws were enacted to set up a functioning mechanism for the GoU to be able to provide back-up funding to the DGF in a timely manner. Amendments to the State Budget Law authorized the MoF to use state bonds for long-term credit to the DGF, while amendments to the DGF Law entitled the DGF to receive back-up funding from the GoU in case its funding ratio falls below 2.5 percent. Finally, as required by the amendments to the DGF Law, a Cabinet of Ministers resolution was passed that described the specific operational details of the back-up funding mechanism.

Prior Action 2: The Borrower has expanded the range of bank resolution instruments and streamlined the resolution process through enactment of the Law "On Amendments to the Legislation on Minimization of Negative Effect on Stability of the Banking System", amending the Law "On Individual Deposit Guarantee System", Official Gazette 4452-VI (23 February 2012), to introduce improved provisions on, inter alia: (a) the use of bridge banks by the DGF without an identified investor; (b) the operation of bad asset entities to consolidate bad assets from multiple banks; and (c) state participation in the bank resolution process.

45. **This prior action supports amendments to the DGF Law to provide the DGF with the additional tools necessary for effective bank resolution.** The amendments are based on the DGF's experience with actual bank resolution cases over the past two years, as well as the need to provide the DGF with the necessary tools to deal with multiple bank failures during a systemic crisis. The amendments passed by Parliament to the DGF Law included provisions on the: (i) use of bridge bank as a resolution instrument[15]; (ii) operations of bad asset entity; and (iii) state participation in the bank resolution process. These tools address three fundamental issues that were identified during the review of the previous legal framework. First, the amendments enable the DGF to establish a bridge bank without an identified investor, put in it the assets and insured deposits from multiple insolvent banks, and extend the lifetime of this institution up to two years. Second, the amendments enable the DGF to consolidate bad assets from multiple banks, which may be necessary when a large number of insolvent banks are transferred to the DGF for resolution. Finally, the amendments establish a mechanism for the state to participate in the resolution of insolvent banks in a limited number of cases in which state involvement could help avoid a potential systemic impact.

Prior Action 3: DGF's administrative council has approved (a) a revised operational budget through Administrative Council Decision #12, dated April 2, 2014, and (b) a staffing plan for 2014, through DGF Executive Directorate decision #066/14, dated April 7, 2014.

46. **The DGF requires an increase in budget and staffing to be adequately prepared to deal with multiple bank failures.** There is a particularly urgent need to increase the operational capacity of the DGF's Bank Resolution Department by optimizing the internal organizational structure and hiring experienced staff/short-term consultants. Thus this prior action supports the DGF in revising its operating budget to allow for the hiring of additional staff to work on

[15] A bridge bank is a temporary bank established to acquire the assets and assume the liabilities of a failed bank (or a number of failed banks). In selected cases it can be the least cost solution if it prevents the further deterioration of the value of a failed bank until a qualified investor can be identified.

temporary administration and liquidation. This has been accomplished through a decision by the DGF's Administrative Council, which approved the hiring of staff in line with the possible number of banks that will need to be resolved by the DGF in 2014. As of June 30, 2014, the number of staff working in the DGF's Bank Resolution Department almost doubled following the adoption of the DGF's Administrative Council decision.

Prior Action 4: The NBU and DGF have signed the "Agreement on Amendment to the Agreement on cooperation and coordination of activities", dated May 8, 2014, to improve the sharing of information on Problem Banks between the two institutions.

47. **This prior action supports improved coordination between the NBU and DGF.** The effective ability of the DGF to plan for a bank resolution is dependent on the availability of timely information about problem banks from the NBU. Even though Article 55 of the original DGF Law, as well as the provisions in a Memorandum of Understanding[16] (MOU) between the NBU and DGF, anticipated substantive and timely exchanges of information by the NBU with the DGF, in practice this coordination has been rather inadequate. To rectify this situation, this prior action supported a revised and expanded MOU between the DGF and NBU that implements the following coordination mechanisms: (i) the sharing of detailed and comprehensive information on problem banks by the NBU with the DGF; (ii) the NBU inviting DGF staff to participate in its supervisory meetings on corrective actions for problem banks; and (iii) the DGF making use of its right to conduct in depth on-site inspections at the problem bank stage. The needed exchange of information envisaged by the revised MOU is already underway, and staff from the DGF are participating in supervisory meetings on problem banks organized by the NBU.

Triggers for FSDPL2

Trigger 1: The state budget law for 2015 includes a back-up funding provision for the DGF and the required funding is provided by the GoU to DGF in accordance with the latter's bank resolution and depositor payout needs.

48. **FSDPL2 will ensure that the DGF has the resources necessary going forward to meet its legally mandated deposit insurance and bank resolution functions.** Considering the overall uncertain economic and political environment and the potential for further shocks that could impact the banking sector, it is likely that additional funding for the DGF will be necessary in 2015. More precise funding need estimates for 2015 will be prepared in the fourth quarter of 2014, and will take into account the results of the bank diagnostic studies.

49. **Results:** Prior actions and triggers for this pillar aim to ensure that the DGF has the adequate operational, financial and regulatory capacity to perform its deposit insurance and bank resolution functions during the current period of significant stress on the banking system. The expected results will be that: (i) the DGF maintains adequate financial capacity (funding ratio); and (ii) the DGF implements an increased number of resolution plans in a timely and quality manner.

[16] This MOU is formally called the "Agreement on cooperation and coordination of activities" and was adopted on July 9, 2012.

Pillar 2: Improving the solvency of the banking system through implementation of recapitalization/ restructuring plans and timely enforcement action

50. **This pillar aims to ensure that all Ukrainian banks are adequately capitalized based on the findings of independent diagnostic assessments and subsequent remedial action to address any weaknesses identified.** Considering the prospects of significant systemic distress, the NBU needs to use the full range of supervisory tools to ensure that banks maintain an adequate level of capital and meet other prudential norms, or face enforcement action. In particular, independent diagnostic assessments of large and medium-sized banks are necessary to ensure the accuracy of balance sheet data and estimate the likely impact of adverse shocks. Based on the findings of these assessments, those banks that are found to be undercapitalized or have other deficiencies will be required by the NBU to prepare and implement time bound recapitalization and restructuring plans. Banks that are unable to complete their recapitalization and restructuring plans within the agreed timeframe will need to be declared insolvent by the NBU and passed to the DGF for resolution, except for a few very large institutions that may need to be recapitalized by the GoU based on clearly defined criteria for the use of public funds.

Prior Action 5: The Borrower's respective authorities have established the key principles of the bank recapitalization and restructuring process through: (a) adoption of NBU Board Decision #326, dated May 30, 2014, on a corrective action plan for dealing with undercapitalized banks; and (b) adoption of the Decision by the high-level GOU/NBU/DGF Steering Committee, dated July 3, 2014, on the criteria for state participation in the bank recapitalization process.

51. **This prior action supports the development and adoption of a corrective action plan that will guide the NBU throughout the bank recapitalization and restructuring process.** This internal NBU document describes the content, timing and sequencing of instruments to be used by the regulator in addressing the current distress[17]. In particular, the action plan outlines the scope and timetable of the planned external diagnostic exercise and subsequent actions expected from bank management and shareholders. The plan also describes the general principles of the enforcement action to be taken by the NBU vis-à-vis various categories of banks not complying with prudential norms, both during the diagnostic exercise and following its completion.

52. **The prior action has also supported the authorities in defining the criteria for the use of public funds in the bank recapitalization process.** The relevant decision adopted by the high level Steering Committee on state participation in bank recapitalization, established by the Cabinet of Ministers resolution and comprised of the Minister of Finance, NBU Governor, the DGF Director, and other senior government and NBU officials, takes into account the lessons from past experience with the use of state funds for bank recapitalization both globally and in Ukraine. In particular, the decision is based on the following principles: (i) limiting the use of state funds to a few large institutions (defined, inter alia, by share held in total assets and deposits) whose failure could cause a major impact on financial stability; (ii) state recapitalization should occur after dilution of existing shareholders; and (iii) ensuring that banks

[17] These instruments include identification of problem banks, enhanced supervision and monitoring, and resolution tools for those banks that are declared insolvent.

with state participation have sound corporate governance. This decision constitutes a solid basis for developing the mechanism and procedures for state entry in undercapitalized banks, and it will be operationalized through the adoption of subsequent laws/regulations that will be supported under FSDPL2.

Prior Action 6: NBU has issued Resolution #272, dated May 12, 2014, on launching independent diagnostic studies for the 35 largest banks, based on acceptable terms of references, and the 15 Largest Banks have each signed a contract with a qualified audit firm.

53. **This prior action supports the NBU in ensuring that the largest 35 Ukrainian banks undergo independent diagnostic assessments to identify any weaknesses in their balance sheets.** This is a critical step in view of the risks resulting from the currency depreciation, as well as concerns about the quality of financial statements and accounting practices in some banks. The results of the independent diagnostic assessments will inform the appropriate remedial action to address major problems in the largest 35 banks that account for more than 80 percent of the banking system assets. Banks are also required to prepare business plans showing how they will meet the minimum capital adequacy requirements through 2016.

54. **As part of this prior action, the diagnostic studies for the 35 largest banks were launched and the top 15 banks have signed a contract with a qualified audit firm.** The diagnostic studies will be completed in two stages, with the largest 15 banks completed by end-July 2014, and the remaining 20 banks completed by end-September 2014. The World Bank, jointly with the IMF, supported the development of the standard terms of reference for the diagnostics that were designed based on the 2014 ECB Asset Quality Review methodology. To ensure the quality of the diagnostic studies, the list of eligible audit firms has been restricted by the NBU (e.g., top 15 banks can only be audited by "Big 4" audit firms), and excludes the firms that have been engaged with a given bank in the previous three years. The diagnostic studies and subsequent remedial actions will be overseen by the NBU's "Coordination Committee on the Control of the Bank Diagnostic Studies", which will include independent observers from the World Bank and IMF.

Triggers for FSDPL2

Trigger 2: Adoption of regulations to operationalize the mechanism for state participation in bank recapitalization, including the details of decision making and governance arrangements.

55. **FSDPL2 will support the operationalization of the mechanism for state participation in bank recapitalization.** While the key principles of state participation are supported under FSDPL1, additional regulations will be needed to operationalize the mechanism. These regulations will be adopted by the time the diagnostic exercise is completed, so as to allow the authorities, with support from the IMF and the World Bank, to come up with a fact-based mechanism that will aim to balance the costs and benefits from different recapitalization options that fit within the criteria adopted as part of FSDPL1.

Trigger 3: Banks complete the implementation of time-bound recapitalization and restructuring plans, as required, based on the results of independent diagnostic studies.

56. **FSDPL2 will support the implementation of bank-specific recapitalization and restructuring plans based on the results of the diagnostic studies.** Following the completion

of the first stage of the diagnostic studies covering the top 15 banks by end-July 2014, the NBU will instruct banks where capital and other deficiencies are identified to submit time-bound recapitalization and restructuring plans for its review and approval by end-September 2014. It is then expected that the top 15 banks will complete the implementation of NBU-approved recapitalization and restructuring plans by end-December 2014. The second group of 20 medium-sized banks is expected to have the diagnostic studies completed by the end-September 2014, and submit the required recapitalization and restructuring plans for NBU's approval by end-November 2014, and complete the implementation of the recapitalization and restructuring plans by the end-February 2015[18]. In all cases, private owners of banks will be asked to meet any capital shortfalls through cash injections.

Trigger 4: The NBU initiates a resolution process for all banks that were unable to implement the required recapitalization and restructuring plans in a timely manner.

57. **FSDPL2 will support the NBU in taking enforcement action on banks that fail to meet capital adequacy requirements.** The NBU, in close consultation with the DGF, will be expected to initiate resolution action for any of the large and medium-sized banks that fail to implement the NBU-approved recapitalization and restructuring plans based on the findings of the diagnostic assessments. A number of smaller banks not subject to diagnostic studies may also need to be declared insolvent and transferred to the DGF for resolution if the owners are unable to meet minimum CAR requirement.

58. **Results:** Prior actions and triggers under this pillar aim to ensure that the entire banking sector is adequately capitalized. Specific results indicators call for the Ukrainian banking system to comply with the minimum CAR requirements (10 percent) by end-2016. This implies that banks with a capital shortfall will need to be recapitalized by then, or be subject to a resolution procedure.

Pillar 3: Strengthening the legal and institutional framework to improve the resiliency and efficiency of the banking system

59. **This pillar supports improvements in the regulatory and institutional framework for the banking sector to make the system more resilient to possible future shocks and facilitate the resumption of sustainable financial intermediation.** The impact of the current economic and political shock on the banking system has been exacerbated by long-standing structural vulnerabilities in the Ukrainian banking system and issues that inhibit the effectiveness of bank supervision. While Pillars 1 and 2 support urgent policy actions necessary to stabilize the banking sector in the short-term, Pillar 3 supports much-needed reforms in the legal and institutional framework that should contribute to developing a more stable and efficient banking system in the medium to long-term. These reforms, many of which seek to apply international best practice to Ukraine's context, include: (i) timely identification of "problem banks"; (ii) improved corporate governance rules and disclosure of ultimate beneficiary owners; (iii) enhanced regulatory and supervisory requirements for domestic systemically important banks; (iv) improved coordination mechanisms among financial safety net players; (v) measures aimed

[18] The timetable for recapitalization and restructuring, while rather ambitious, is consistent with experience from Ukraine's 2008-2009 banking crisis, and with the timetable set in the IMF's SBA.

at promoting the consolidation of the banking sector; (vi) adoption of needed legal and regulatory changes aimed at facilitating the NPL resolution process; and (vii) implementation of a time-bound strategy for divestiture of those banks that are recapitalized with the state's participation during the previous crisis.

Prior Action 7: The Borrower and NBU have introduced additional criteria for the timely identification of Problem Banks through: (a) enactment of the Law "On Amendments to the Legislation on Minimization of Negative Effect on Stability of Banking System", amending the Law on Banks; and (b) adoption of NBU Regulation #332, issued June 3, 2014.

60. **The timely identification of problem banks by the NBU is a key part of the financial safety system that requires urgent improvement.** Eleven banks have been declared insolvent and passed to the DGF for resolution since the beginning of 2014, and in many cases they were identified as problem banks by the NBU's supervision department at nearly or exactly the same time as when they were declared as insolvent. It is critical that the NBU's supervision department declares a bank as a problem bank at the first signs of a bank's weakness and takes prompt corrective action and introduces an enhanced supervision regime. Since intensive information sharing and coordination between the NBU and the DGF is supposed to start when a bank is classified as a problem bank by the NBU, the late identification of problem banks also impairs the ability of the DGF to prepare for an effective and least-cost resolution. The delayed identification of problem banks also allows for asset stripping, which significantly restricts the DGF's ability to use resolution options other than liquidation.

61. **This prior action supports the adoption of additional triggers for identifying problem banks.** As a part of the overall effort to improve supervisory effectiveness, the new management of the NBU is committed to improving the mechanism for identifying problem banks. To that end, this prior action supports the adoption of a number of additional criteria for putting a bank in the problem category through: (i) amendments to the Law on Banks introducing new quantitative criteria related to capital adequacy, liquidity and quality of bank assets, and (ii) adoption of a special NBU regulation that introduces several additional qualitative criteria[19]. If properly enforced, these changes should allow the NBU to subject weak banks to an enhanced supervision regime, and allow for the engagement by the DGF at an early stage in order to effectively prepare for a potential resolution.

Prior action 8: The Borrower has strengthened the corporate governance requirements of commercial banks through enactment of the Law "On Amendments to the Law on Banks and Banking on defining the Peculiarities on Corporate Governance in Banks", amending the Law on Banks and Banking.

62. **This prior action supports changes to the Law on Banks that aim to enhance corporate governance practices within banks.** There are significant weaknesses in the corporate governance framework for banks that need to be addressed to improve the efficiency and resiliency of the banking system. To that end, amendments enacted to the Law on Banks include, inter alia, the following provisions: (i) more effective distribution of powers and

[19] These criteria include: non-compliance with NBU other regulations and/or requests to eliminate violations of banking legislation, failure to disclose bank beneficiary owners, public conflicts at bank, failure to comply with NBU order to remove from office bank officials.

responsibilities between the banks' shareholders' assembly, supervisory board and executive management; (ii) strengthened internal audit requirements; and (iii) enhanced professional requirements for supervisory board members and bank management.

Prior Action 9: The NBU has commenced disclosure of banks' ultimate beneficiary owners as evidenced by up-to-date and accurate ownership information about the 35 Largest Banks published on the NBU website.

63. **This prior action supports the proper disclosure of bank's ultimate beneficiary owners.** Full disclosure of ultimate beneficiary owners is essential for transparency, corporate governance and supervisory effectiveness. In particular, this information allows the regulator to properly implement consolidated supervision and related party lending regulations. Although the special law passed in 2011 required Ukrainian banks to disclose up-to-date information about their significant ultimate beneficiary owners (i.e., owners with >10 percent of total equity) on their websites and the NBU website, a number of banks, particularly with domestic owners, did not fully comply. The management of the NBU that came into office following the political changes in February 2014 has declared the full implementation of this law as one of its top priorities, and has indicated a willingness to take enforcement action as necessary to ensure compliance. As a result, the requirements of the law on disclosure of banks' ultimate beneficiary owners have by now been met for the largest 35 banks, with up-to-date and accurate information published by end-May 2014 on the NBU website. The website also includes the same information for all Ukrainian banks that have declared ultimate beneficiary owners in control of >10 percent of equity.

Triggers for FSDPL2

Trigger 5: The Borrower establishes a high-level Financial Stability Council, comprised of NBU, MoF, DGF and two other financial sector regulators.

64. **FSDPL2 will support the establishment of an effective coordination mechanism among financial sector policy makers.** Lessons from recent financial crises indicate that coordination among financial safety net stakeholders in both normal and crisis times is critical for maintaining financial stability. To improve this coordination, FSDPL2 will support the establishment of a high-level Financial Stability Council comprised of the heads of the NBU, MoF, DGF and two other financial sector regulators. This council, supported by an NBU-based secretariat, will meet on a regular basis to discuss the potential risks to the country's financial stability and possible remedial actions required if the risks materialize.

Trigger 6: The authorities adopt regulations aimed at the consolidation of the banking system (e.g., streamlined M&A procedure, stronger monitoring and enforcement of related party lending limits, etc.).

65. **With 181 banks operating in Ukraine as of end-2013, the consolidation of the banking system is a major policy priority.** FSDPL2 will support legal and regulatory changes to make consolidation a more attractive option, including streamlining of mergers and acquisition (M&A) procedures, stronger monitoring of related party lending limits, and an increase in the minimum capital requirements. These changes should encourage smaller banks to merge or be sold to bigger players in the market.

Trigger 7: The authorities enact regulations to address impediments for effective NPL out-of-court restructuring, sale, and write-off.

66. **The authorities are committed to developing a more effective NPL resolution framework.** The ongoing economic and currency crisis is likely to lead to a further rise in NPLs, on top of the 23.5 percent broadly defined NPL level at end-2013. This likely further deterioration of the loan portfolio will squeeze banks' profitability and ability to lend, which in turn will continue to impair economic growth in the country. To assist banks in effectively dealing with these non-performing assets, FSDPL2 will support specific changes in laws and regulations to remove the existing impediments and disincentives for out-of-court restructuring, sale and write-off of NPLs by banks.

Trigger 8: NBU adopts regulations setting special regulatory and supervisory requirements for systemically-important banks.

67. **An enhanced supervisory framework for domestically important systemic banks will be established.** In line with enhanced risk monitoring and supervision, new Basel 3 requirements on capital surcharges for systemic banks will be introduced by an NBU special regulation, while allowing the banks adequate time for compliance. To further strengthen the resilience of systemic banks and increase the preparedness for dealing with potential future crisis situations in a timely and orderly manner, the NBU will also adopt regulations mandating systemic banks to periodically prepare and submit their recovery plans to the NBU.

Trigger 9: Progress in implementation of a time-bound strategy for divestiture of banks recapitalized with the state's participation.

68. **The GoU needs to plan and implement an exit strategy for the banks that were recapitalized by the state during the 2008-09 crisis.** The divestiture of the state's stake in Ukrgasbank, Kyiv Bank and Rodovid Bank has been delayed due to a lack of political commitment and an unfavorable market environment. It is expected that the GoU under FSDPL2 will make tangible progress towards exiting from these three banks. Proposed solutions include the eventual privatization of Ukrgasbank that results in its sale to a strategic investor, and the merger or liquidation of the two other, smaller institutions.

69. **Results**: The prior actions and triggers supported under this pillar are expected to lead to the improved resiliency and efficiency of the banking system. Specific results will pertain to: (i) the reduction in a number of banks operating in Ukraine; and (ii) the adoption of recovery plans by D-SIBs.

Table 5: FSDPL1 Prior Actions and Analytical Underpinnings

Prior actions	Analytical Underpinnings
Pillar 1. Strengthening the operational, financial and regulatory capacity of the DGF for the resolution of insolvent banks	
Prior Action 1: The Borrower has strengthened DGF's financial capacity by establishing a mechanism for long-term back-up funding from the Borrower, through enactment of the Law "On Amendments to the State Budget Law of Ukraine of Year 2014", and adoption of the Cabinet of Ministers Resolution.	FIRST Bank Resolution TA (P147676)
Prior Action 2: The Borrower has expanded the range of bank resolution instruments and streamlined the resolution process through enactment of the Law "On Amendments to the Legislation on Minimization of Negative Effect on Stability of the Banking System", amending the Law "On Individual Deposit Guarantee System", Official Gazette 4452-VI (23 February 2012), to introduce improved provisions on, *inter alia*: (a) the use of bridge banks by the DGF without an identified investor; (b) the operation of bad asset entities to consolidate bad assets from multiple banks; and (c) state participation in the bank resolution process..	Financial Sector Monitoring and TA (P146563, P132228); FIRST Bank Resolution TA (P147676, P146563)
Prior Action 3: DGF's administrative council has approved (a) a revised operational budget through Administrative Council Decision #12, dated April 2, 2014, and (b) a staffing plan for 2014, through DGF Executive Directorate decision #066/14, dated April 7, 2014.	FIRST Bank Resolution TA (P147676, P144089)
Prior Action 4: The NBU and DGF have signed the "Agreement on Amendment to the Agreement on cooperation and coordination of activities", dated May 8, 2014, to improve the sharing of information on Problem Banks between the two institutions.	FIRST Bank Resolution TA (P147676, P144089)
Pillar 2. Improving the solvency of banking system through implementation of bank recapitalization/ restructuring plans and timely enforcement action	
Prior Action 5: The Borrower's respective authorities have established the key principles of the bank recapitalization and restructuring process through: (a) adoption of NBU Board Decision #326, dated May 30, 2014, on a corrective action plan for dealing with undercapitalized banks; and (b) adoption of the Decision by the high-level GOU/NBU/DGF Steering Committee, dated July 3, 2014, on the criteria for state participation in the bank recapitalization process.	Financial Sector Monitoring and TA (P146563, P132228)
Prior Action 6: NBU has issued Resolution #272, dated May 12, 2014, on launching independent diagnostic studies for the 35 largest banks, based on acceptable terms of references, and the 15 Largest Banks have each signed a contract with a qualified audit firm.	Financial Sector Monitoring and TA (P146563, P132228)
Pillar 3: Strengthening the legal and institutional framework to improve resiliency and efficiency of the banking system	
Prior Action 7: The Borrower and NBU have introduced additional criteria for the timely identification of Problem Banks through: (a) enactment of the Law "On Amendments to the Legislation on Minimization of Negative Effect on Stability of Banking System", amending the Law on Banks and Banking; and (b) adoption of NBU Regulation #332, issued June 3, 2014.	Financial Sector Monitoring and TA (P146563, P132228)
Prior Action 8: The Borrower has strengthened the corporate governance requirements of commercial banks through enactment of the Law "On Amendments to the Law on Banks and Banking on defining the Peculiarities on Corporate Governance in Banks", amending the Law on Banks and Banking.	Financial Sector Monitoring and TA (P146563, P132228)
Prior Action 9: The NBU has commenced disclosure of banks' ultimate beneficiary owners as evidenced by up-to-date and accurate ownership information about the 35 Largest Banks published on the NBU website.	Financial Sector Monitoring and TA (P146563, P132228)

4.3. LINK TO CPS AND OTHER BANK OPERATIONS

70. **This programmatic DPL series is aligned with the strategic directions set out in the CPS (FY12-16), which envisaged a calibrated engagement depending on the pace and**

strength of reforms. The CPS is structured around two pillars: (i) improving public services and public finances; and (ii) improving policy effectiveness and economic competitiveness. One of the key policy areas under the second pillar is financial sector stability and development. The lending engagement was calibrated to the pace and strength of reforms, leaving scope for a programmatic DPL series focused on the financial sector reform agenda. The FSDPL series was prepared in parallel to a complementary Fiscal Adjustment and Institutional Reform DPL series[20] that aims to: (i) promote good governance, transparency, and accountability in the public sector; (ii) strengthen the regulatory framework and reduce costs of doing business; and (iii) reform inefficient and inequitable utility subsidies while protecting the poor.

71. **In response to the changing political and economic circumstances in Ukraine, the World Bank Group has committed to provide up to US$3.5 billion in 2014 alone** including: 1) US$1.5 billion in Development Policy Loans (DPLs) to support structural reforms and banking sector stabilization; 2) US$1.6 billion in investment lending to improve public service delivery in district heating, water and sanitation, health, the power sector, and social assistance; and 3) US$400 million in lending and investment by the IFC to support the private sector.

72. **The proposed FSDPL series should also be seen as a cornerstone of the broader program to support Ukraine's financial sector development.** In addition to this DPL series, this program includes a number of IBRD, IFC and MIGA products with specific financial intermediaries as well as extensive advisory services/ technical assistance engagement by the joint WB-IFC Finance and Markets Global Practice.

4.4 CONSULTATIONS AND COLLABORATION WITH DEVELOPMENT PARTNERS

73. **Despite the condensed preparation time for the FSDPL1, discussions have been conducted with key domestic stakeholders, IFIs and development partners.** The World Bank team has supported the authorities' outreach to the banks that operate in Ukraine, as well as civil society organizations regarding the reform program supported by the FSDPL series. In early June 2014 the NBU hosted a one-day round-table with leading commercial banks and representatives of host supervisors, under the auspices of the Vienna Initiative, to seek support from the sector for the reform program. The NBU and the DGF also meet regularly with NGOs representing the interests of depositors. Finally, the legislative changes supported under FSDPL1 were subject to active debate in Parliament's committee with the participation of banking sector representatives.

74. **The World Bank has also collaborated closely with the IMF and other development partners in the course of preparing this operation.** The World Bank team leads a coordination group for financial sector work in Ukraine that includes all multilateral and bilateral donors active in the area. The World Bank is closely collaborating with the United States Agency for International Development (USAID) on the DGF reform agenda, and with the European Bank for Reconstruction and Development (EBRD), as it is currently considering complementary actions aimed at strengthening the financial and operational capacity of the DGF.

[20] The first Fiscal Adjustment and Institutional Reform Development Policy Loan (US$750 million) was approved by the Board of Executive Directors on May 22, 2014.

5. OTHER DESIGN AND APPRAISAL ISSUES

5.1 POVERTY AND SOCIAL IMPACT

75. **The measures supported by FSDPL1 focus on urgent actions that are necessary to minimize the potential impact of a full-blown banking crisis that would lead to an increase in poverty in Ukraine.** Based on current projections, the expected contraction of the economy by 5 percent in 2014 could lead to an increase in poverty of 2.1 percentage points[21] (equivalent to more than 900,000 people) if all households were equally exposed to a shock. However, the increase in poverty would be much higher if poorer groups are less able to protect themselves from macro-economic shocks.[22] A banking crisis, if it were to occur, would cause economic conditions to further deteriorate and contribute to further increases in the poverty rate in Ukraine. Thus the policy measures supported in FSDPL1 that focus on urgent actions that are necessary to minimize the risk of a loss of depositor confidence are critical to containing an increase in poverty in 2014 and beyond.

76. **The measures supported by the FSDPL series specifically aim to protect depositors by strengthening the DGF that insures deposits up to a certain coverage limit in the case of a bank failure.** This is critical for minimizing the potential increase in poverty. Protecting deposits in the banking system will be especially important for those that are poor and among the bottom 40 percent of the population as they are the most vulnerable if their savings were lost due to a bank failure. According to the 2012 Household Budget Survey, 19 percent of poor households have savings in a financial institution in Ukraine, with those who were saving reporting to be saving 16 percent of their income. For the bottom 40 percent, 16 percent of households have savings in a financial institution, with those who were saving reporting that they saved 10 percent of their income. Data from the Global Financial Inclusion Database (FINDEX) for 2011 also highlights the crucial role that savings play in people's livelihoods, with 15 percent of individuals saving for emergencies (with no significant gender differences in this respect)[23].

77. **The improvements in the resiliency and efficiency of the financial sector that are the primary focus of the policy measures supported by FSDPL2 are expected to, among other things, increase access to financial services and strengthen the livelihoods of the poor.** According to the latest household budget survey, access to financial services has increased for the population as a whole from 17 to 21 percent from 2007 to 2012.[24] This increase has also been recorded for the bottom decile (roughly equivalent to the poor) and for the bottom 40 percent: from 6 to 9 percent and from 10 to 14 percent, respectively. According to the survey data,

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

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

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

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

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

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

5.2 ENVIRONMENTAL ASPECTS

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

5.3 PFM, DISBURSEMENT AND AUDITING ASPECTS

80. **Public Financial Management.** The latest available Public Expenditure and Financial accountability (PEFA) assessment for Ukraine was undertaken in 2011. It concluded that Ukraine continues to have in place fundamental systems for macro-fiscal management, some elements of a framework to enable strategic allocation of resources, and selected tools for improving operational efficiency. The PEFA found that a consistent driver of performance improvement was expansion in the use of the Treasury system, supporting adequate internal controls and reporting. Key findings of the assessment were that weaknesses remain in: (i) disconnects between policy objectives, recurrent budget allocations, and decisions on capital investment; (ii) a fragmented budget with large special purpose extra-budgetary funds for social insurance etc. that are not subject to the same standards of financial reporting and oversight by parliament and the Supreme Audit Institution; (iii) a target driven approach to revenue collection that negatively impacted the cost of doing business; (iv) deficient oversight of state owned enterprises; (v) flaws in public procurement that limited competitiveness; (vi) limited focus on systems performance by the internal audit function; (vii) limitations on the scope of work of the Supreme Audit Institution and weaknesses in parliamentary oversight. There are ongoing reforms supported by Bank financed operations in several of these areas, and the most critical have been considered and included in policy recommendations, prior actions and triggers for the Fiscal Adjustment and Institutional Reform DPL series.

81. **Fiduciary Risk.** This assessment concludes that fiduciary risk for DPLs is substantial. This rating considers proposed prior actions and also takes into account: (i) ongoing PFM reform efforts currently being supported by the Bank, including support for modernizing public procurement legislation; (ii) modernization of treasury operations; and (iii) strengthening effectiveness of the Accounting Chamber (Supreme Audit Institution) and the Public Internal Financial Audit and Control function. It also considers the ongoing escalation of political and economic situation in Ukraine and uncertainties surrounding its possible impact on the NBU control environment.

82. **Foreign Exchange.** The IMF conducted a Safeguards Assessment of the NBU in 2011. The assessment observed that the NBU had strengthened its safeguards framework since the

2008 assessment by implementing the majority of the related recommendations. While certain changes to the NBU law were enacted in 2010, deferred implementation of key improvements was observed to weaken their effectiveness. The updated assessment also found that new financial risks had emerged because of special legislation and resolutions impairing the NBU's autonomy. The NBU continues to make progress towards addressing unresolved issues, none of which directly impacts this operation. The IMF is currently conducting a new NBU safeguards assessment and will finalize it during 2014. The report will provide updated knowledge of the borrower's central bank foreign exchange environment.

83. **The most recent audit opinion on the financial statements of the NBU for the financial year ending December 31, 2013 was unmodified.** However, the audit report included an "emphasis of matter" statement in which the auditors drew attention to disclosures in the financial statements that described the escalation of the political and economic situation in Ukraine that started in November 2013 and continued in 2014. The statement observed that these events could affect the results and financial position of the NBU in a manner that was not then determinable.

84. **Disbursement Arrangements.** This operation is a single-tranche loan of US$500 million. The loan proceeds will be made available to the Government upon loan effectiveness and meeting of the withdrawal conditions. Upon approval of the loan and notification by the Bank of loan effectiveness, the Government will submit a withdrawal application. The proceeds of the loan will be deposited by the International Bank for Reconstruction and Development (IBRD) in an account designated by the Borrower and acceptable to the World Bank at the NBU. The Borrower should ensure that upon the deposit of the loan proceeds into the said account, an equivalent amount in local currency is credited into the Treasury current account at the NBU. If the proceeds of the loan are used for ineligible purposes (e.g., to finance goods or services on the Bank's standard negative list), the Bank will require the Government to promptly, upon notice from the Bank, refund an amount equal to the amount of said payment to the Bank. Amounts refunded to the Bank upon such request shall be cancelled. This condition will be reflected in the terms of the Loan Agreement (LA). The Government will maintain accounts and records showing that the loan disbursements were made in accordance with provisions of the LA. Within seven days of remittance of funds by the Bank, the Borrower will provide a confirmation to the Bank that the funds have been received by the treasury account in the NBU and that these funds are available for financing budget expenditures.

85. **Overall Conclusion.** The public financial management systems, together with the Borrower's commitment to reform, are adequate to support this operation.

5.4 MONITORING AND EVALUATION

86. **The World Bank will work closely with the DGF, MoF, and NBU to monitor and assess reform progress and impact during the course of the FSDPL series.** Monitoring and evaluation will be supported by data that are readily available by the DGF, MoF and NBU. Baseline and updated data will be provided by each of these institutions and tracked according the list of quantitative results indicators included in the Policy and Results Matrix (Annex 1).

6. SUMMARY OF RISKS AND MITIGATION

87. **Risks to this operation are high and can be grouped as follows:**

- ***Political risks.*** The effectiveness of the banking sector stabilization measures supported by FSDPL1 depend, to a large extent, on having a stable government formed on the basis of a parliamentary majority and committed to implementing longer-term structural reforms. Increased political instability in Ukraine would negatively impact public confidence in the banking sector. In particular, further escalation of tensions in the east of the country could lead to accelerated deposit outflows and losses for banks operating in that region. While this risk is hard to mitigate completely, there seems to be consensus across the political spectrum that the stability of the banking system is critical for the economy. Bank staff will also continue to reach out to representatives of all major political groups and stakeholders through work with committees in Parliament and general public advocacy efforts.

- ***Geo-political risks.*** Escalation or widening of regional tensions could have serious economic consequences because Ukraine has strong ties with the Russian economy. Around a quarter of Ukraine's exports find their way to the Russian market. In addition, Ukraine imports around 60 percent of the gas needed for domestic consumption from the Russian Federation. Disruption in exports and/or gas supplies could seriously affect Ukraine's economic prospects in the short run and these risks cannot be mitigated by this operation.

- ***Macroeconomic risks***. The risks outlined in Section 2 of this PD could affect the implementation, impact and sustainability of the reforms supported by this series. Possible macroeconomic instability and/or deepening banking crisis would undermine the adequacy of the macroeconomic framework that underpins this operation. These risks are partially mitigated by recent steps taken by the authorities to stabilize the economy, underpinned by a two-year SBA with the IMF. In addition, the two World Bank DPL series (including this one) also help to mitigate these risks.

- ***Social, environmental and fiduciary risks.*** Social risks are low as the operation will support the Government's efforts to minimize the potential of a full-blown banking crisis that would have a significant negative impact on the population. The operation also does not entail environmental risks. Fiduciary risks are substantial due to remaining weaknesses in the PFM system. This risk is partially mitigated by the ongoing PFM reform efforts being supported by the Bank, including support for modernizing public procurement legislation through the Fiscal Adjustment and Institutional Reform DPL series.

- ***Governance risks.*** Ukraine has a record of endemic corruption and capture of public institutions. Although the vested interest groups are lying low in the wake of recent protests, in the longer run they may seek to undermine the bank restructuring program supported by FSDPL1. In particular, the private bank owners may attempt to delay/avoid putting in additional capital as required, or to pass the recapitalization burden to the state. This risk will be mitigated through supporting the independent diagnostic assessment of large and medium-sized banks as part of World Bank and IMF programs, putting in place clear eligibility criteria and governance arrangement for state recapitalization as a measure of last resort, and strengthening the capacity of the DGF to resolve the banks

that fail to implement the recapitalization and restructuring plans. It is also worth noting that the Ukrainian authorities (including NBU's top management) that came to office as a result of regime change earlier in 2014 have stated their strong commitment to improve governance and transparency of decision-making.

- ***Implementation risks.*** The risk of lack of follow-through action after FSDPL1 is significant considering that Ukraine's previous financial sector DPL series in 2009-2010 was not satisfactorily completed after the first operation. Given the urgent need to support the stabilization of the banking sector, FSDPL1 is primarily focused on putting in place an improved institutional and legal framework for dealing with systemic distress, specifically through strengthening the DGF capacity. Having a good framework is an essential first step, but it must be followed by resolute enforcement action. In particular, the NBU, in coordination with the DGF and MoF, will need to enforce implementation of bank-specific recapitalization and restructuring plans based on the findings of the diagnostic studies, or initiate resolution of insolvent banks. The risk of not being able to complete the FSDPL series is mitigated through having an agreement with the authorities on a longer-term policy program supported by the programmatic FSDPL series (see Letter of Development Policy in Annex 2), with FSDPL2 conditioned upon the implementation of bank recapitalization process. Financial sector conditionality in the parallel, two-year IMF's SBA and EC's macro-financial assistance will also help ensure the authorities' commitment to longer-term reforms. At the same time, the FSDPL series will be supplemented with extensive technical assistance effort by the World Bank Group and other donors in all three pillars to ensure proper institutional capacity and sustainability of reforms. Finally, the signing of the Association Agreement and Deep and Comprehensive Free Trade Agreement with the EU provides a strong anchor for implementation of structural reforms in the financial sector.

ANNEX 1: UKRAINE PROGRAMMATIC FINANCIAL SECTOR DEVELOPMENT POLICY LOAN - POLICY AND RESULTS MATRIX

Prior Actions FSDPL 1	Triggers FSDPL 2	Results
Pillar 1: Strengthening the operational, financial and regulatory capacity of the DGF for resolution of insolvent banks		
Prior Action 1: The Borrower has strengthened DGF's financial capacity by establishing a mechanism for long-term back-up funding from the Borrower, through enactment[25] of the Law "On Amendments to the State Budget Law of Ukraine of Year 2014" and adoption of the Cabinet of Ministers Resolution. **Prior Action 2:** The Borrower has expanded the range of bank resolution instruments and streamlined the resolution process through enactment of the Law "On Amendments to the Legislation on Minimization of Negative Effect on Stability of the Banking System", amending the Law "On Individual Deposit Guarantee System", Official Gazette 4452-VI (23 February 2012), to introduce improved provisions on, *inter alia*: (a) the use of bridge banks by the DGF without an identified investor; (b) the operation of bad asset entities to consolidate bad assets from multiple banks; and (c) state participation in the bank resolution process. **Prior Action 3:** DGF's administrative council has approved (a) a revised operational budget, through Administrative Council Decision #12, dated April 2, 2014, and (b) a staffing plan for 2014, through DGF Executive Directorate decision 066/14, dated April 7, 2014. **Prior Action 4:** The NBU and DGF have signed the "Agreement on Amendment to the Agreement on cooperation and coordination of activities", dated May 8, 2014, to improve the sharing of information on Problem Banks between the two institutions.	**Trigger 1:** The state budget law for 2015 includes a back-up funding provision for the DGF and the required funding is provided by the GoU to DGF in accordance with the latter's bank resolution and depositor payout needs.	DGF maintains adequate financial capacity (funding ratio) Baseline (Q12014): 3.30% Target (2016): >2.5% Number of bank resolution plans implemented by DGF (cumulative) Baseline (2013): 2 Target (2016): 20

[25] Enactment means legislation is approved by Parliament, signed by the President, and published in official gazette.

Pillar 2: Improving the solvency of the banking system through implementation of bank recapitalization/ restructuring plans and timely enforcement action		
Prior Action 5: The Borrower's respective authorities have established the key principles of the bank recapitalization and restructuring process through: (a) adoption of NBU Board Decision #326, dated May 30, 2014, on a corrective action plan for dealing with undercapitalized banks; and (b) adoption of the Decision by the high-level GOU/NBU/ DGF Steering Committee, dated July 3, 2014, on the criteria for state participation in the bank recapitalization process. **Prior Action 6:** NBU has issued Resolution #272, dated May 12, 2014, on launching independent diagnostic studies for the 35 largest banks, based on acceptable terms of references, and the 15 Largest Banks have each signed a contract with a qualified audit firm.	**Trigger 2:** Adoption of regulations to operationalize the mechanism for state participation in bank recapitalization, including the details of decision making and governance arrangements. **Trigger 3:** Banks complete the implementation of time-bound recapitalization and restructuring plans, as required, based on the results of independent diagnostic studies. **Trigger 4:** The NBU initiates a resolution process for all banks that were unable to implement the required recapitalization and restructuring plans in a timely manner.	Banking system remains adequately capitalized (% CAR) Baseline (2014, 1st qtr.): 14.8% Target (2016): > 10%

Pillar 3: Strengthening the legal and institutional framework to improve resiliency and efficiency of the banking system		
Prior Action 7: The Borrower and NBU have introduced additional criteria for the timely identification of Problem Banks through: (a) enactment of the Law "On Amendments to the Legislation on Minimization of Negative Effect on Stability of Banking System", amending the Law on Banks and Banking; and (b) adoption of NBU Regulation #332, issued June 3, 2014. **Prior Action 8:** The Borrower has strengthened the corporate governance requirements of commercial banks through enactment of the Law "On Amendments to the Law on Banks and Banking on defining the Peculiarities on Corporate Governance in Banks", amending the Law on Banks and Banking. **Prior Action 9:** The NBU has commenced disclosure of banks' ultimate beneficiary owners as evidenced by up-to-date and accurate ownership information about the 35 Largest Banks published on the NBU website.	**Trigger 5:** The Borrower establishes a high-level Financial Stability Council, comprised of NBU, MoF, DGF and two other financial sector regulators. **Trigger 6:** The authorities adopt regulations aimed at the consolidation of the banking system (e.g., streamlined M&A procedure, stronger monitoring and enforcement of related party lending limits, etc.). **Trigger 7:** The authorities enact regulations to address impediments for effective NPL out-of-court restructuring, sale, and write-off. **Trigger 8:** NBU adopts regulations that set special regulatory and supervisory requirements for systemically-important banks. **Trigger 9:** Progress in implementation of a time-bound strategy for divestiture of banks recapitalized with the state's participation.	Consolidation of banking sector in Ukraine (number of banks) Baseline (2013): 181 banks Target (2016): 150 banks Adoption of recovery plans by domestic systemically important banks (D-SIBs) Baseline (2013): 0 Target (2016): all banks classified as D-SIBs

ANNEX 2: LETTER OF DEVELOPMENT POLICY

8737/0/2-14 від 08.07.14

Лист Уряду України і Національного банку про політику розвитку у фінансовому секторі

Шановний пане Кім!

Уряд України і Національний банк користуються цією нагодою, щоб висловити свою глибоку повагу Світовому банку і Вам особисто, і мають честь повідомити Вам про таке. Ми високо цінуємо підтримку Вами стратегії реформ фінансового сектору в Україні та очікуємо, що наше партнерство в рамках нової позики на політику розвитку у фінансовому секторі сприятиме стабілізації фінансового сектору в Україні та створенню умов для його реструктуризації.

Макроекономічна база

З огляду на складну економічну ситуацію Уряд України розпочав здійснення заходів, спрямованих на стабілізацію макроекономічної ситуації. Українська економіка перебуває у кризовому стані через складну ситуацію на зовнішньому ринку і незавершені структурні реформи. У 2013 році рівень внутрішнього валового продукту не зріс, а залишився на рівні попереднього року. Поштовхом для економічного зростання було внутрішнє споживання, але його позитивний ефект послаблено наявним структурним дисбалансом в Україні. Обмежений унаслідок високої вартості коштів позик доступ до фінансових ресурсів, необхідних для підтримки платіжного балансу і модернізації економіки, та відсутність стимулів для інвестицій негативно вплинули на економічні перспективи України. Разом з тим збільшилися зовнішній дисбаланс, а на валютному ринку посилилося очікування девальвації національної валюти. Міжнародні резерви знизилися до критичного рівня. Прагнучи стабілізувати ситуацію, Національний банк вдався до адміністративних заходів і на початку 2014 року перейшов до гнучкого обмінного курсу, зміцнивши контроль за потоками капіталу. Однак це сталося із запізненням, і

ситуація на валютному ринку стала ще більш напруженою. Дисбаланс у системі державних фінансів, невідповідність бюджетної та податкової політики економічним реаліям, посилення адміністративного тиску на платників податків і розширення тіньової економіки призвели до зростання дефіциту консолідованого бюджету та державного боргу.

Ми визнаємо, що на сьогодні економічна ситуація в Україні складна, і вживаємо необхідних заходів. Зокрема, Україна домовилася з МВФ про програму макроекономічної стабілізації "Стенд-бай". Уряд України і Національний банк вживають узгоджених заходів до реалізації податково-бюджетної політики, а також грошово-кредитної політики, яка спрямована на ліквідацію диспропорцій платіжного дисбалансу та перехід до таргетування інфляції. Пріоритетом податково-бюджетної політики буде поступове зниження дефіциту бюджету. У цьому контексті для нас дуже важлива фінансова підтримка міжнародних організацій і насамперед Світового банку.

Фінансовий сектор

Політична нестабільність та економічна криза у країні, а також суттєва девальвація національної валюти з початку 2014 року призвели до нестабільності фінансового сектору, зниження довіри населення до банківської системи, відпливу коштів з банків, насамперед вкладів фізичних осіб, скорочення обсягів кредитування, погіршення якості кредитів.

Зокрема, обсяг коштів фізичних осіб на рахунках у банках за п'ять місяців поточного року скоротився на 19 відсотків*, з них відплив вкладів у національній валюті становив 16 відсотків, а в іноземній валюті – 23 відсотки. З огляду на це Національний банк додатково до традиційного механізму підтримки ліквідності запровадив надзвичайні інструменти підтримки та збереження ліквідності банків, завдяки чому вдалося зберегти достатній рівень ліквідності в банківській системі.

Напружене соціально-економічне середовище в Україні призвело до зменшення на 5 відсотків обсягів кредитування банками економіки та погіршення платоспроможності позичальників як юридичних, так і фізичних осіб, що вплинуло на якість кредитних операцій банків. Обсяг негативно-класифікованих кредитів за п'ять місяців 2014 року зріс на 27 відсотків і становить 14,7 відсотка загального обсягу кредитів (на початок 2014 року – 12,9 відсотків).

---

*Дані наводяться без урахування валютних коливань.

У результаті погіршення економічних умов 10 банків з початку 2014 року було визнано Національним банком неплатоспроможними і передано Фонду гарантування вкладів фізичних осіб (далі – Фонд) для санації або впорядкованого виведення з ринку.

З огляду на таку ситуацію у фінансовому секторі Уряд України разом з Національним банком зобов'язалися вжити належних заходів до мінімізації тиску на банківську систему і відновлення довіри до неї населення та інших інвесторів. Уряд України і Національний банк вживають оперативних скоординованих заходів, спрямованих на стабілізацію ситуації у фінансовому секторі в короткостроковій перспективі та підвищення його стійкості та ефективності функціонування в середньостроковій перспективі. У цьому контексті ми високо цінуємо підтримку, яку отримуємо від Світового банку, МВФ, ЄБРР, а також інших донорів.

Порядок денний реформ

Уряд України і Національний банк започаткували комплексну програму антикризового управління у фінансовому секторі, завданням якої є мінімізація можливості широкомасштабної дестабілізації у фінансовому секторі і в економіці загалом. Оскільки існує ймовірність того, що нинішній тиск на фінансовий сектор зберігатиметься впродовж певного часу, ми вживаємо термінових заходів для мінімізації можливих додаткових банкрутств банків і забезпечення розв'язання будь-яких проблем їх платоспроможності, щоб уникнути фінансової кризи.

Фінансова криза, яка мала місце в Україні у 2008–2009 роках, продемонструвала необхідність забезпечити наявність у Фонда достатнього потенціалу для розв'язання проблем неплатоспроможних банків і того, щоб подальше втручання держави через рекапіталізацію або інші методи не могло призвести до серйозних руйнацій у всій фінансовій системі. Зважаючи на це Уряд України приділяє значну увагу необхідності збільшення фінансових і операційних ресурсів, наявних у Фонда для забезпечення будь-яких процесів ліквідації банків, які відбуваються, на основі найменших витрат, а вкладникам застрахованих вкладів негайного надання компенсації відповідно до Закону України "Про страхування вкладів". Водночас ми визнаємо, що Національний банк повинен мати всебічну та достовірну інформацію про фінансовий стан діючих банків для забезпечення рекапіталізації або реструктуризації банків, у яких буде виявлено потребу в капіталі, насамперед за рахунок коштів їх власників.

Отже, наша програма антикризового управління у фінансовому секторі зосереджується на вирішенні трьох питань:

проведення оцінки стійкості банків, які працюють в Україні;

реструктуризація і рекапіталізація банків, що здійснюються для мінімізації витрати Уряду України та можливості системної кризи;

виведення з ринку банків, які вважаються нежиттєздатними, що здійснюватиметься Фондом – органом, що законодавчо наділений відповідними повноваженнями.

Додатково до діючої програми антикризового управління ми маємо намір здійснити також більш масштабну реструктуризацію фінансового сектору з метою підвищення ефективності та стабільності сектору в довгостроковій перспективі. Це передбачатиме внесення ряду змін до законів і нормативно-правових актів, які будуть спрямовані на поліпшення корпоративного управління, консолідацію банківського сектору та скорочення обсягу проблемних кредитів.

Зважаючи на багаторічну історію ефективної співпраці із Світовим банком, ми просимо Банк підтримати нашу політику розвитку для України у фінансовому секторі.

Поступ у Першій позиці на політику розвитку у фінансовому секторі

У рамках виконання комплексної програми антикризового управління у фінансовому секторі Уряд України активно вживає узгоджених із Світовим банком заходів до підготовки позики на політику розвитку за такими основними напрямами:

зміцнення операційного, фінансового та регуляторного потенціалу Фонду;

поліпшення платоспроможності банківської системи шляхом виконання планів рекапіталізації/реструктуризації банків;

зміцнення правової та інституційної бази для підвищення стійкості та ефективності банківської системи в довгостроковій перспективі.

Уряд України повністю здійснив попередні заходи, узгоджені в рамках Першої позики на політику розвитку у фінансовому секторі (далі – Проект).

У зв'язку з цим внесено зміни до Законів України "Про внесення змін до деяких законів України щодо упередження (мінімізації) негативного впливу на стабільність банківської системи" і "Про Державний бюджет України на 2014 рік" (щодо фінансової підтримки Фонду гарантування вкладів фізичних осіб), що передбачають визначення комплексного та прозорого механізму надання Урядом України резервного фінансування Фонду для забезпечення його спроможності виплачувати вкладникам їх застраховані кошти і ліквідовувати банки з найменшими витратами. Крім того, внесення таких змін розширить перелік інструментів ліквідації банків і підвищить їх ефективність з метою забезпечення мінімізації вартості ліквідації будь-якого банку для громадян України. Ці інструменти передбачають перегляд законодавчої бази для банку-санатора та можливість Уряду України взяти участь у процесі ліквідації неплатоспроможного банку в разі, коли це системоутворюючий банк.

Для зміцнення оперативного потенціалу Фонду так, щоб ця установа могла впоратися з імовірним збільшенням робочого навантаження:

рішенням Адміністративної ради Фонду збільшено бюджет та кількість штатних працівників Фонду;

внесено зміни до Меморандуму порозуміння та співробітництва між Національним банком та Фондом для того, щоб гарантувати, що Фонд має належну інформацію про проблемні банки, які потенційно можуть стати неплатоспроможними.

Ми також продовжуємо роботу, спрямовану на забезпечення належної платоспроможності банківської системи. З цією метою Правлінням Національного банку прийнято рішення щодо проведення незалежного діагностичного обстеження 35 найбільших за розміром активів банків, яке здійснюватиметься відповідно до Технічного завдання, узгодженого із Світовим банком і МВФ. На даний час підписано контракти з відповідними аудиторськими фірмами для 15 найбільших банків, які планується виконати до серпня 2014 року. Діагностичні оцінки для решти 20 банків буде виконано до жовтня 2014 року. Після завершення проведення оцінок акціонерам банків буде надано до п'яти місяців для підготовки та виконання у разі потреби планів рекапіталізації та реструктуризації банків. Очікуючи на результати діагностики, Національний банк ухвалив план коригуючих заходів із зазначенням строків їх здійснення та загальних принципів програми рекапіталізації і реструктуризації банків, що має

забезпечити як прозорість, так і ефективність цієї програми.

Ми визнаємо необхідність зміцнення нашої нормативно-правової бази, яка стосується питань виявлення та роботи з проблемними банками, щоб збільшити ймовірність утримання їх життєздатності, забезпечуючи водночас здійснення їх ліквідації на основі найменших витрат, у разі, коли зберегти їх життєздатність не вдасться. Для виконання цього завдання ми схвалили зміни, що вносяться до нормативно-правових актів, щодо встановлення додаткових тригер для проблемних банків.

Визнаючи, що неефективне корпоративне управління було одним з основних чинників, який призвів до нинішньої нестабільності в банківському секторі, ми домоглися того, що інформація про кінцевих власників-бенефіціарів банків для найбільших банків доступна Національному банку і належним чином оприлюднюється на його сайті. Ця інформація має вирішальне значення для визначення та контролю обсягів кредитування пов'язаних осіб і покращення корпоративного управління та прозорості у фінансовому секторі. Ми також внесли зміни до Закону України "Про банки і банківську діяльність" (щодо визначення особливостей корпоративного управління в банках), які мають на меті посилення вимог до банків щодо корпоративного управління.

Кроки з реалізації реформ фінансового сектору

Ще раз прийміть, будь ласка, запевнення щодо нашої незмінної рішучості впроваджувати програму реформ, яким надається підтримка в рамках Проекту. Орієнтуючись на заходи, яким надається підтримка в рамках Проекту, ми маємо намір здійснити додаткові заходи, які є частиною нашої програми. Зокрема, ми прагнемо і далі забезпечувати Фонд фінансовими та операційними ресурсами, достатніми для ліквідації будь-яких додаткових банків, які стануть неплатоспроможними і Національний банк передасть фонду для ліквідації на основі найменших витрат. З цією метою ми готові забезпечувати надання державою Фонду резервних коштів у разі, коли резерви Фонду знизяться більш як на 2,5 відсотка застрахованих вкладів. Ми також забезпечимо стабільність банківського сектору, використовуючи результати діагностичних досліджень для 35 найбільших банків як підставу для вимог щодо рекапіталізацію/реструктуризацію тих банків, що не відповідають вимогам щодо мінімального капіталу. Ми визначимо чіткі критерії та механізми управління можливого використання державних коштів для рекапіталізації банків, а також запровадимо стратегію (з установленням конкретних строків її реалізації) продажу активів банків, для яких

здійснюватиметься рекапіталізація за рахунок державних коштів.

Ми будемо також продовжувати реформи і дії, спрямовані на створення більш стабільного, ефективного та гнучкого фінансового сектору. З цією метою ми розпочали розроблення механізму створення комітету високого рівня, до якого увійдуть головні учасники системи безпеки фінансового сектору, для забезпечення координації їх дій. Ураховуючи, що багато банків, які працюють в Україні, відчули на собі нестабільність в секторі, ми сповнені рішучості провести основні реформи, необхідні для підтримки консолідації сектору. Високий показник непрацюючих кредитів також є серйозним бар'єром для поліпшення роботи фінансового сектору, тому ми впровадимо комплексну програму з метою внесення змін до законодавства, що полегшить усунення таких кредитів з балансу банків, які працюють в Україні. Зважаючи на важливість системоутворюючих банків для покращення фінансової системи, ми будемо піддавати ці банки посиленим заходам нагляду та регулювання.

З огляду на зазначене Уряд України просить Світовий банк надати позику на розвиток фінансового сектору в сумі 500 млн. доларів США (у рамках позик на політику розвитку) для сприяння стабілізації банківського сектору і створення підґрунтя для реструктуризації фінансового сектору. Уряд України зосередить свої зусилля на виконанні майбутньої програми позик на політику розвитку у фінансовому секторі. Відповідно до рішення Кабінету Міністрів України відповідальність за виконання цієї програми буде покладено на Міністерство економічного розвитку і торгівлі України.

Прем'єр-міністр України **Арсеній ЯЦЕНЮК**

Голова
Національного банку **Валерія ГОНТАРЕВА**

July 8, 2014

Letter from the Government of Ukraine and the National Bank of Ukraine on Development Policy in Financial Sector

Dear Mr. Kim,

The Government of Ukraine and the National Bank take this opportunity to express its profound respect for the World Bank and you personally, and have the honor to inform you as follows. We highly appreciate your support to financial sector reform in Ukraine and expect our partnership within the scope of the new Financial Sector Development Policy Loan, FSDPL-1, to contribute to stabilizing the financial sector in Ukraine and laying the groundwork for its restructuring.

Macroeconomic Framework

In view of the difficult economic situation, the Government of Ukraine has started implementing actions aimed at stabilizing the macroeconomic framework. The Ukrainian economy is in crisis condition due to the complicated situation on external market and unfinished structural reforms. The 2013 GDP stagnated staying at the level of the previous year. Economic growth was driven by domestic consumption, but its positive effect was weakened by existing structural imbalance in Ukraine. Limited access to financial resources to support the balance of payments and modernization of the economy due to the high cost of borrowings, as well as the lack of incentives for investments affected the economic prospects of Ukraine. Meanwhile, external imbalances deepened, while devaluation expectations grew stronger on the foreign exchange market. International reserves dropped to a critical level. To stabilize the situation, the National Bank of Ukraine resorted to administrative measures and, in early 2014, shifted to a flexible current rate, while strengthening controls over capital flows. However, this happened with a delay and the situation on the currency market remained tense. Imbalance in the public finance system, the incompatibility of fiscal and tax policies with economic realities, increased administrative pressure on taxpayers, and an expanding shadow economy resulted in growing consolidated budget deficit and public debt.

We acknowledge that the current economic situation in Ukraine is complicated and we are taking necessary policy measures. In particular, Ukraine has agreed on a Stand-By macroeconomic stabilization program with the IMF. The Government of Ukraine and the National Bank are taking coordinated fiscal and monetary policy measures aimed at eliminating balance-of-payment imbalance and shifting to inflation targeting. The priority of fiscal policy will be gradual budget deficit reduction. In this context, emergency financial support from international institutions, first and foremost, from the World Bank, is extremely important for us.

Financial Sector

Political instability and economic crisis in the country, as well as the significant devaluation of local currency from the beginning of 2014 resulted in instability of the financial

sector causing deterioration of trust to the banking system, the outflow of funds from banks, especially the retail deposits, decline in lending volumes and the deterioration of loan quality.

In particular, the amount of retail deposits at banks in five months of this year fell by 19 percent [26] (not adjusted for currency fluctuations), that includes the outflow of deposits in local currency of 16 percent and in foreign currency – 23 percent. With this in mind, the National Bank, in addition to the traditional mechanism to support liquidity, introduced special tools for supporting the liquidity of banks, which helped keep sufficient liquidity in the banking system.

Tense social and economic environment in Ukraine led to a 5 percent decrease in bank lending to the economy and caused deterioration of solvency of borrowers, both corporate and individuals, which affected the quality of credit. The volume of negatively classified loans in 5 months of 2014 increased by 27 percent to comprise 14.7 percent of gross loans (at the beginning of 2014 - 12.9 percent).

As a result of deteriorating economic conditions 10 banks have been recognized as insolvent by the National Bank since the beginning of 2014 and transferred to the Deposit Guarantee Fund (hereinafter the Fund) for the resolution.

In view of this situation in the financial sector, the Government of Ukraine and National Bank pledged to take appropriate policy measures to minimize pressure on the banking system and restore its credibility with the public and other investors. The Government of Ukraine and the National Bank shall take coordinated prompt measures to stabilize the financial sector in the short term and increase its stability and efficiency of the medium term. In this context, we appreciate the support we receive from the World Bank, IMF, EBRD, as well as other donors.

Reform Agenda

The Government of Ukraine and the National Bank have launched a comprehensive financial sector crisis management program that aims to minimize the potential for a wide scale disruption in the financial sector and the overall economy. With the likelihood that the current pressure on the financial sector will remain for some time, we are taking swift action to minimize the potential for additional bank failures and ensuring that any failures that do occur are resolved in a way that minimizes the possibility of a financial crisis.

The financial crisis that occurred in Ukraine in 2008-09 demonstrated the need to ensure that the Deposit Guarantee Fund has adequate capacity to deal with failing banks, and that the state participation via recapitalization or other methods should prevent the potential significant disruption in the entire financial system. To this end, the Government of Ukraine has prioritized the need to increase the financial and operational resources available to the DGF to ensure that any bank failures that do occur are resolved on a least-cost basis while insured depositors are promptly compensated as per the Law on Deposit Guarantee System. At the same time, we recognize the need for the National Bank to have comprehensive and accurate information on the financial state of active banks in order to ensure recapitalization or restructuring of banks, at which the capital deficiency will be found, first of all by their owners.

[26] Excluding the currency fluctuation effect

Thus our financial sector crisis management program focuses on three areas:

1. assessing the resilience of the banks that operate in Ukraine;
2. restructuring and recapitalizing banks in a manner that minimizes the costs to the government while minimizing the potential for a systemic crisis;
3. resolving those banks that are deemed to be unviable through the resolution authority in Ukraine, the Deposit Guarantee Fund.

In addition to current crisis management program, we are also committed to a broader scale restructuring of the financial sector in order to improve the efficiency and stability of the sector in the longer run. This will involve a number of legal and regulatory changes that will focus on improving corporate governance, consolidating the banking sector and reducing the volume of non-performing loans.

In view of the multi-year background of efficient cooperation with the World Bank, we are asking the Bank to support our development policy for Ukrainian financial sector.

Progress under First Financial Sector Development Policy Loan

As part of implementation of comprehensive financial sector crisis management program, the Government of Ukraine is pro-actively taking measures agreed with the World Bank to prepare the development policy loan in the following areas:

- strengthening the operational, financial and regulatory capacity of the DGF;
- improving the solvency of the banking system through implementation of recapitalization/ restructuring plans;
- strengthening the legal and institutional framework to improve the resiliency and efficiency of banking system in the longer term.

The Government of Ukraine has fully complied with prior actions agreed under the First Financial Sector Development Policy Loan.

In connection with this, the following legislative amendments have been made: “On amending certain laws of Ukraine on prevention or minimization of negative impact on the stability of banking system” and “On the state budget of Ukraine for 2014” (concerning financial support of the Deposit Guarantee Fund. The amendments determine comprehensive and transparent mechanism for providing the DGF with back-up funding from the Government of Ukraine to ensure its ability to pay out insured depositors and resolve banks on a least-cost basis. In addition, the amendments also broaden the range of resolution tools and the effectiveness of these tools to ensure that the cost to the citizens of Ukraine from any bank failures is minimized. These tools include a revised bridge bank framework and the ability of the Government of Ukraine to participate in the resolution of an insolvent bank in the case of systemically important institutions.

In order to strengthen the operational capacity of the DGF so that this institution can deal with the likely increase in its workload the following has been done:

- increased the budget and staffing level through a decision of the DGF Administrative Council.

- amended the Memorandum of understanding and cooperation between the National Bank and the DGF to ensure that the Fund has the appropriate information on problem banks that could potentially become insolvent

We also continue the work on ensuring the solvency of the banking system by issuing orders by the National Bank for the top 35 banks by assets to conduct independent diagnostic assessments using the terms of reference that were agreed with the World Bank and the IMF. Contracts for the top 15 banks have already been signed with qualified audit firms, with the work to be completed by the beginning of August, 2014. The remaining 20 banks will be completed by the beginning of October, 2014. Following the completion of assessments, the bank shareholders will be given up to five months to prepare and implement the recapitalization and restructuring plans, as necessary. While awaiting the results of the diagnostic, the NBU has adopted a corrective action plan outlining the timetable and general principles of the bank recapitalization and restructuring program which aims to make the program both transparent and effective.

We have recognized the need to strengthen our framework for identifying and dealing with problem banks to increase the likelihood of maintaining their viability or, if this is not possible, ensuring that they are resolved in a timely manner using least-cost basis. In order to accomplish this, we have approved regulatory changes that set the additional triggers for identifying problem banks.

Recognizing that ineffective corporate governance has been one of the major factors that has contributed to the current instability in the banking sector, we have ensured that the information about the banks' ultimate beneficiary owners for the large banks is available to the NBU and properly disclosed on the NBU website. This information is critical to establish and control volumes of related party lending and improve corporate governance and transparency in the financial sector. We have also amended the "Law on Banks and Banking" in order to strengthen the corporate governance requirements for banks.

Next steps in Implementation of the Financial Sector Reforms

Please be re-assured that we remain committed to the implementation of the reform program supported by the Project. Building on the measures supported under FSDPL1, we are committed to implementing the additional measures that are part of our program. Specifically we aim to continue to ensure that the DGF has the adequate financial and operational resources to resolve any additional banks that become insolvent and are transferred to it by the NBU for least-cost resolution. To this end, we stand ready to provide back-up funding to DGF from the state should the DGF reserves decline below 2.5 percent of total insured deposits. We will also ensure the stability of the banking sector by using the results of the diagnostic studies of the top 35 banks as a basis to require the recapitalization/restructuring of those banks that do not meet the minimum capital requirements. We will design and adopt the clear criteria and governance mechanisms for the potential use of state funds for bank recapitalization, and will also put in place a time-bound strategy for the sale of assets of banks that are recapitalized using state funds.

We will also continue to pursue reforms and actions aimed at building a more stable, efficient and agile financial sector. To this end, we have started to develop a mechanism for a high-level committee with key financial sector safety net participants to ensure coordination of

their actions. Considering that the large number of banks that operate in Ukraine have felt the current instability in the sector, we are committed to making key reforms that are required to support the consolidation of the sector. The high level of non-performing loans is also a key barrier in improving the performance of the financial sector, and we will put in place a comprehensive changes in legal and regulatory program aimed at facilitating the removal of these NPLs from the balance sheets of the banks that operate in Ukraine. Considering the importance of systemically important banks to improvement of the financial system, we will subject these banks to enhanced supervision and regulation.

In the light of the above-stated, the Ukrainian authorities request the World Bank to provide a Financial Sector Development Policy Loan in the amount of US$500 million (as part of series of development policy loans), in order to contribute to the stabilization of the banking sector and lay the groundwork for the restructuring of the financial sector. The Ukrainian authorities will focus our efforts on implementing the programmatic financial sector development policy loan series. According to the decision by the Cabinet of Ministers of Ukraine, the Ministry of Economic Development and Trade shall be in charge of the Program implementation.

Prime Minister Arseniy Yatsenyuk

NBU Governor Valeriia Gontareva

ANNEX 3: FUND RELATIONS ANNEX

IMF Announces Staff Level Agreement with Ukraine on First Review under the Stand-By Arrangement

Press Release No. 14/351
July 18, 2014

An International Monetary Fund (IMF) mission visited Kyiv during June 24-July 17, to hold discussions on the first review under the Stand-By Arrangement (SBA) in support of the authorities' economic reform program. At the conclusion of the visit, Mr. Nikolay Gueorguiev, mission chief for Ukraine, made the following statement today in Kyiv:

"The mission has reached understandings with the Ukrainian authorities on the policies necessary for the completion of the first review under the SBA (see Press Release No. 14/189). In this regard, the authorities have committed to take a number of policy actions prior to the completion of the review. As is usual practice, the understandings reached with the authorities are subject to approval by IMF management while the completion of the review is subject to approval by the Executive Board. The completion of the review would enable the disbursement of SDR 914.67 million (about US$1.4 billion).

"The mission found that policies have generally been implemented as planned and that all but one of the performance criteria for end-May have been met. All structural benchmarks for the first review have been met as well, although some of them with a delay. This is a notable achievement as the intensification of the conflict in the East means that the program has been implemented in an environment that is considerably more difficult than anticipated when it was launched.

"The conflict is putting increasing strain on the program and a number of key elements of the macroeconomic framework have had to be revised: (i) economic prospects have deteriorated notably, and GDP is now expected to contract by 6.5 percent this year, compared to 5 percent when the program was adopted; (ii) a shortfall in revenue collections in the East, higher security spending, and lower-than-expected debt collection by Naftogaz will cause fiscal and quasi-fiscal deficits and financing needs to rise above the programmed path; and (iii) higher-than-expected capital outflows and monetization of fiscal deficits are causing pressures on net international reserves.

"Notwithstanding the authorities' continued commitment to the program and good record of implementation so far, the authorities have decided to take a number of compensatory measures to limit the negative impact of the conflict in the short run, and ensure that key program objectives are achieved over the period of the two-year program:

• On fiscal policy, the authorities have decided to implement a package of revenue and expenditure measures, amounting to 1 percent of GDP in 2014, offsetting the effect of increased security spending by other expenditure cuts. They have also committed to limiting wage and pension increases to the level of inflation in 2015, continuing reform-based reduction in public sector employment, and exercising tight control over discretionary spending.

• In the energy sector, the authorities are taking additional actions to strengthen payment discipline and compliance, such as pursuing payments from collectible accounts and seizing assets if repayment is not forthcoming. They are also preparing to restructure Naftogaz with a view to

improve the transparency of its operations and reduce costs.

• In the area of monetary policy, the program will allow for a larger drawdown of net international reserves to prevent destabilizing exchange rate movements. But the National Bank of Ukraine (NBU) will limit the decline in reserves through some purchases from the market, and it has reiterated that it stand ready to achieve the revised path for net international reserves by allowing the Hryvnia to depreciate, if necessary. Meanwhile, the NBU will continue to upgrade its monetary policy framework with a focus on domestic price stability and prepare for inflation targeting. The operational framework and financial position of the Deposit Guarantee Fund are being enhanced as well to maintain confidence in its ability to execute its mandate.

• The authorities are taking steps toward strengthening governance and improving the business climate. A recent diagnostic study has identified major areas for reforms. Based on the study's recommendations the authorities plan to implement a wide range of anti-corruption measures, including establishment of an independent anti-corruption agency with broad investigative powers and adoption of legislative amendments to support the anti-corruption effort.

"On the strength of these compensatory measures and continued implementation of other policies agreed when the program was approved, staff is confident that the program can achieve its fundamental objectives of restoring internal and external macroeconomic equilibrium, generating sound and sustainable economic growth, and strengthening economic governance and transparency. In particular, while the combined fiscal and quasi fiscal deficits are projected to amount to 10.1 and 5.8 percent of GDP in 2014 and 2015, respectively—compared to previous targets of 8.5 and 6.1 percent—the structural adjustment is stronger by ½ percent of GDP over 2014-16 and the headline deficit will be below the originally programmed path by 2016. Similarly, gross reserves will be only some US$3.4 billion lower than programmed by end-2015. While external debt to GDP will peak 7 percentage points higher than programmed at end-2015, it will be on a steady downward slope by the end of the program, suggesting that external viability is not at risk.

"The program hinges crucially on the assumption that the conflict will begin to subside in the coming months. While the authorities' determined implementation of the program so far, including the compensatory measures agreed in the context of the current review, augur well for their ability to continue to adjust the program as circumstances evolve, a significant prolongation of the crisis would seriously strain their ability to do so without a substantial increase in external support on adequate terms. Fund staff will remain in close consultation with the authorities and their international partners as the situation unfolds."