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INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

PROGRAM DOCUMENT FOR A PROPOSED LOAN

IN THE AMOUNT OF US$500 MILLION

TO UKRAINE

FOR THE

SECOND PROGRAMMATIC FINANCIAL SECTOR DEVELOPMENT POLICY LOAN

August 25, 2015

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

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UKRAINE: GOVERNMENT FISCAL YEAR
January 1 – December 31

CURRENCY EQUIVALENTS
(Exchange Rate Effective as of August 19, 2015)

Currency Unit = Ukrainian Hryvnia (UAH)
US $1.0 = UAH 22.09

ABBREVIATIONS AND ACRONYMS

CAR	Capital Adequacy Ratio
CPS	Country Partnership Strategy
DGF	Deposit Guarantee Fund
DPL	Development Policy Loan
DSA	Debt Sustainability Analysis
EBRD	European Bank for Reconstruction and Development
EC	European Commission
EFF	Extended Fund Facility
ECA	Europe and Central Asia
FDI	Foreign Direct Investment
FY	Fiscal Year
GDP	Gross Domestic Product
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
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
US$	United States Dollar
VAT	Value Added Tax

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UKRAINE

SECOND PROGRAMMATIC FINANCIAL SECTOR DEVELOPMENT POLICY LOAN

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SUMMARY OF PROPOSED LOAN AND PROGRAM

UKRAINE

SECOND 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: Variable spread with 17 years total maturity, including 6 years of grace period Front End Fee: 0.25 percent Amount: US$500 million
Operation Type	Programmatic (2 of 2); Single tranche
Pillars of the Operation And Program Development Objective(s)	The Project Development Objective is to support the authorities in: (i) strengthening the operational, financial and regulatory capacity of the Deposit Guarantee Fund 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 the resiliency and efficiency of the banking system.
Result Indicators	*Pillar 1:* • Depositors reimbursed in banks that were declared insolvent in 2014 and 2015 • Number of bank resolution plans implemented by the DGF *Pillar 2:* • Bank recapitalization plans approved by the NBU for the top 20 banks (or resolution of those that cannot be agreed to) based on revised diagnostic studies • Capital Adequacy Ratio (CAR) for the top 20 banks that underwent the updated diagnostic process *Pillar 3:* • Consolidation of banking sector in Ukraine (number of banks) • Agreement on related-party lending unwinding plans by the top 10 banks (or resolution of those banks that cannot agree on plans)
Overall risk rating	High
Operation ID	P151941

IBRD PROGRAM DOCUMENT FOR A PROPOSED

SECOND PROGRAMMATIC FINANCIAL SECTOR DEVELOPMENT POLICY LOAN TO UKRAINE

1. INTRODUCTION AND COUNTRY CONTEXT

1. **The Second Programmatic Financial Sector Development Policy Loan (FSDPL2) supports a series of high-priority reform measures in the banking sector in response to the financial crisis in Ukraine.** The proposed FSDPL2 is the second in a series of two operations and is in the amount of US$500 million. The objective of the proposed FSDPL series is to support 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 the resiliency and efficiency of the banking system. The FSDPL series is part of a coordinated package of international assistance to support Ukraine in undertaking critical structural reforms, restore confidence, and to meet external and fiscal financing needs. The timing and policy content of the operation is closely coordinated with the IMF Extended Fund Facility (EFF), which was approved on March 11, 2015, as well as support from other bilateral and multilateral partners.[1]

2. **The reforms supported by the FSDPL series are being implemented against a backdrop of an economic and financial crisis that is compounded by conflict in eastern Ukraine.** The political protests that began in October 2013 culminated in a change of Government in late February 2014 and election of a new President three months later. Parliamentary elections were held in October 2014, and a new government was formed in December 2014. The new government has begun work on an ambitious reform agenda supported by the IMF and World Bank, but faces daunting challenges: tackling a major banking crisis; containing conflict and restoring peace in the east; ensuring macroeconomic stability; reducing the fiscal deficit in the midst of a recession without triggering social unrest and backlash against reforms; and fighting endemic corruption while contending with powerful vested interests that continue to oppose reforms.

3. **While the authorities began an ambitious macroeconomic adjustment in early 2014, the escalating conflict in eastern Ukraine in the second half of the year and ensuing loss of confidence prevented the adjustment program from achieving its intended objectives**. Ukraine is in the midst of a protracted economic recession accompanied by a large budget deficit, rising public and external debt, sharply depreciating exchange rate, surging inflation and a banking crisis. Disruptions to industrial production in the conflict-affected regions exacerbated the economic contraction. Weak revenue performance, especially in the east, higher security-related expenditures, and large financing needs for Naftogaz[2] hampered fiscal adjustment. On the external side, the current account started to adjust following the depreciation but balance of payments

[1] The World Bank is working with numerous development partners, including the European Commission (EC), the Governments of Japan, Norway, Germany, and the United States, as well as other International Financial Institutions (IFIs) such as the European Bank for Reconstruction and Development (EBRD). The Japanese and Norwegian governments are co-financing the multi-sector DPL and the German government is using prior actions for FSDPL2 related to the DGF as part of its disbursement conditions for its EUR200 million loan to Ukraine.

[2] National Oil and Gas Company of Ukraine.

pressures remain acute. Delays in official inflows, low foreign direct investment (FDI), and capital outflows put pressure on the currency which depreciated sharply since the beginning of last year. Reserves declined to a low level and Ukraine's external financing needs to cover the balance of payments and rebuild reserves increased significantly.

4. **The banking sector in Ukraine is under extreme stress.** The banking system has lost about 52 percent of foreign exchange denominated deposits and 29 percent of Hryvnia denominated deposits from end-December 2013 to end-June 2015. Since the beginning of 2014, 54 out of 180 banks operating as of January 1, 2014 (including the fourth, tenth, sixteenth and seventeenth largest banks by assets) have failed and were transferred to the DGF for resolution. The level of non-performing loans (NPLs) has increased from 12.9 percent at end-December 2013 to 24.3 percent at end-June 2015. This level is expected to continue to rise in the coming months as losses due to the currency depreciation and the conflict in the east are properly accounted.

5. **The FSDPL series supports the authorities in taking decisive action to deal with the current crisis and strengthen the banking system.** The series is anchored in three pillars that support the government's reform program in the financial sector. Pillar 1 focuses on strengthening the capacity of the DGF to ensure that it can adequately perform its critical bank resolution and insured deposit payout functions. Pillar 2 focuses on ensuring that adequate solvency of the banking system is maintained through development and implementation of bank-specific recapitalization/restructuring plans and timely enforcement action. Pillar 3 supports legal and institutional reforms necessary to improve the resiliency and efficiency of the banking system in the medium to longer term.

6. **The FSDPL series has been adjusted due to the worsening conditions in the banking sector and overall economy, as well as the conflict in the east.** The FSDPL series was prepared as the economy and banking sector had experienced a significant shock in early 2014, but with the expectation that there would be a rebound in the economy in 2015. The macroeconomic situation and banking sector have deteriorated since Board approval of the First Programmatic Financial Sector Development Policy Loan (FSDPL1) in August 2014. This is largely due to the escalating conflict in the east and the significant currency depreciation. In response to this, the prior actions for FSDPL2 have been significantly strengthened. Pillar 1 has been strengthened to support the authorities in addressing key operational deficiencies in the DGF that became apparent as the number of bank failures increased. Pillar 2 has been strengthened to include the launching of an updated set of diagnostic studies to ensure that the banking system is adequately capitalized, while also supporting the authorities in implementing the recapitalization and restructuring program for the top banks based on diagnostic studies conducted in mid-2014 as envisaged when the FSDPL series was prepared. Finally, Pillar 3 has been strengthened to increase the focus on reducing related-party lending in the system as it became apparent during the past year that the levels in the system were much higher than expected.

7. **The authorities have taken bold steps to stabilize the banking sector in response to the deepening crisis in Ukraine.** The authorities have conducted independent diagnostic studies of the top 35 banks in 2014 to ensure that the largest banks in Ukraine were adequately capitalized. Those banks that were found to be undercapitalized have either implemented recapitalization or restructuring programs based on the results of the diagnostic studies or have been resolved after being unable to provide the needed capital. It is important to note that no public funds have been

utilized to date to recapitalize the banks whose private shareholders failed to provide capital. Rather these banks have all been resolved using the normal bank resolution framework.

8. **The authorities have also taken actions to address endemic corruption and remove linkages between powerful vested interests in the banking sector that are needed to build a healthier and more viable banking sector.** Supervision of the banking sector was relatively poor prior to the crisis, which partially led to a system that had numerous weak banks that primarily served the interests of the owners. This led to a banking sector that had an large number of banks (180 as of January 1, 2014), with many of these banks serving primarily as low cost funding source for the business interests of their owners. The authorities have taken decisive steps to remove these weak banks from the system and reduce the level of related-party lending in the system, and in doing so have taken politically difficult decisions in spite of the often significant political power of bank owners in Ukraine.

9. **The risks to the program remain high.** The FSDPL series supports the authorities in taking decisive action to stabilize the financial sector in the midst of the current crisis, and implement key measures needed to reform the sector over the medium term. Given the depth of the current crisis, significant risks in the financial sector remain and require the implementation of a longer-term government program in spite of the progress that the authorities have made. This longer-term program will continue along the three pillars of the operation and will include: (i) continued strengthening of the operational capacity of the DGF; (ii) implementation of recapitalization requirements based on updated diagnostic studies for the top 20 banks; and (ii) improving the resiliency and efficiency of the banking sector by completing the related-party lending diagnostic review, putting in place measures to facilitate the reduction of NPLs, and improving supervision of the financial system. The risks related to ensuring the longer-term commitment to the government reform program in the financial sector are mitigated by ongoing World Bank technical assistance (TA) and policy dialogue, as well as the financial sector policies included in the IMF EFF, which will anchor the needed macroeconomic adjustment and structural reforms in the banking sector over a four-year period. There are also significant risks to the overall economy that could undermine the impact of the policy program in the financial sector supported by this DPL. While the confrontation in the east abated following the Minsk II agreement,[3] there is a considerable risk that the conflict may continue flaring up periodically and undercut efforts to stabilize the economy. Moreover, while the exchange rate has stabilized since March, instability could reemerge, especially as administrative controls in the currency market are relaxed. Higher-than-expected depreciation and inflation would, in turn, increase pressures in the banking sector.

10. **The crisis threatens to reverse some of the gains Ukraine made in reducing poverty and boosting shared prosperity.** Rapid growth before the global economic crisis resulted in a decline in the poverty rate from 23.2 percent in 2007 to 6.2 percent in 2013.[4] From 2008 to 2013, the average income of the bottom 40 percent grew 50 percent faster than that of the rest of the population (4.2 percent vs. 2.8 percent annually), reflecting higher wage increases (4.6 percent vs. 2.7 percent annually). However, real incomes, including those of the poor and of the bottom 40 percent are under pressure as a result of the economic contraction, banking crisis, rising

[3] The Minsk II arrangement was signed by Governments of Ukraine and the Russian Federation, the Organization for Security and Cooperation in Europe, and representatives of some parts of Luhansk and Donetsk oblasts on February 12, 2015.
[4] World Bank staff calculations using the actual income distribution and poverty line of 2012 fixed in real terms. This avoids the problems of adopting official poverty lines in Ukraine that are not constant in terms of purchasing power.

unemployment, pension and wage freezes, high inflation, and large increases in utility tariffs. Pension freezes affect women disproportionately as 70 percent of single pensioners are women and their pensions are 30 percent lower on average than those of men (as a result of a 26 percent wage gap and a difference of 5 years in retirement age in favor of men). After years of robust growth, domestic consumption is estimated to have declined by 7.4 percent in 2014 and by 15.4 percent in the first quarter of 2015. Poverty is estimated to have increased to 11.4 percent in 2014 and is expected to rise again in 2015 to at least 20.6 percent[5] given the challenging economic outlook. If macroeconomic and fiscal challenges intensify, there are risks of an even bigger poverty increase. The eastern regions, which tended to be poorer even before the conflict, are the most affected with internally displaced people being particularly vulnerable to becoming poor. The UN estimates that 60 percent of those displaced are women.

11. **The FSDPL series 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.** Global experience has shown that financial crises tend to disproportionally impact the poor and the bottom 40 percent. The policy reforms supported by the FSDPL series aim to minimize the short-term impact of the banking crisis on the poor and bottom 40 percent. Pillar 1 focuses on strengthening the financial and operational capacity of the DGF and will ensure that almost all[6] of the poor and bottom 40 percent have their savings fully reimbursed in the case of a bank failure. The reforms supported by Pillar 3 focus on creating a healthier and more viable banking sector, which will lead to increased access to finance for the poor and bottom 40 percent in the medium to longer-term.

12. **The FSDPL series is aligned with the strategic directions set out in the FY12-16 Country Partnership Strategy (CPS), which envisaged a calibrated World Bank Group engagement based 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, the World Bank provided no budget support to Ukraine to support financial sector reforms during the CPS period prior to the current financial crisis. Instead, policy dialogue was sustained through TA based on a programmatic financial sector TA program. The World Bank has increased its lending and TA in the financial sector since the current crisis began in early 2014, and the FSDPL series is part of this increased support.

13. **In conjunction with the financial sector reforms supported by this operation, a complementary multi-sector DPL series supports difficult but much-needed structural reforms to set the economy on a sustainable growth path.** The series 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. The first operation of the multi-sector DPL series was approved by the Board of Executive Directors on May 22, 2014 and the second was approved on August 25, 2015. The content of the FSDPL series is fully aligned with the financial sector program supported by the IMF EFF, with both supporting complementary policy reforms needed to stabilize

[5] These estimates are based on a scenario of distributionally neutral contractions of 6.8 percent in 2014 and 12 .0 percent in 2015. To the extent that the poor are more vulnerable to different shocks, poverty could be higher.
[6] The DGF insures deposits up to UAH 200,000 (or about US$9,000) and fully covers 98 percent of all household depositors in Ukraine.

the banking system and build a healthier and more viable banking system.

2. MACROECONOMIC POLICY FRAMEWORK

14. **Despite decisive efforts by the authorities to stabilize the economy, several risks identified in the FSDPL1 document have materialized**. The macroeconomic situation has deteriorated since the FSDPL1 Board approval, largely because of the escalating conflict and the ensuing loss of confidence. Disruptions to industrial production in the east and conflict-induced uncertainty hurt exports, exacerbated the recession, amplified fiscal pressures, and fueled capital outflows, which in turn led to sharp currency depreciation. GDP declined by 6.8 percent in 2014 (Figure 1). The currency depreciated by about 50 percent in 2014, which together with increases in utility tariffs, pushed 12-month consumer price inflation to 24.9 percent y/y in December. Weak revenue collections from the east, higher spending on security, and a higher quasi-fiscal deficit of Naftogaz (in part due to the depreciation) hampered efforts to reduce fiscal imbalances. The overall fiscal deficit, including Naftogaz, widened to an estimated 10.1 percent of GDP in 2014 (Figure 2). With most of the debt denominated in foreign currency, the large depreciation and the GDP contraction resulted in the debt-to-GDP-ratio increasing to 70.3 percent despite a slightly smaller fiscal deficit (Figure 3). While the external current account deficit adjusted sharply following the currency depreciation (Figure 4), balance of payment pressures remained significant in 2014 because of delays in official financing, low FDI, and capital outflows fueled by uncertainty. External financing needs to cover the balance of payment shortfall and rebuild reserves are estimated at US$40 billion (equal to about 40 percent of GDP) during 2015-2018.

Despite stabilization efforts the macroeconomic situation deteriorated largely due to escalating conflict in the east

Figure 1:
Ukraine faces a deeper and more protracted recession…
(GDP, percent change)

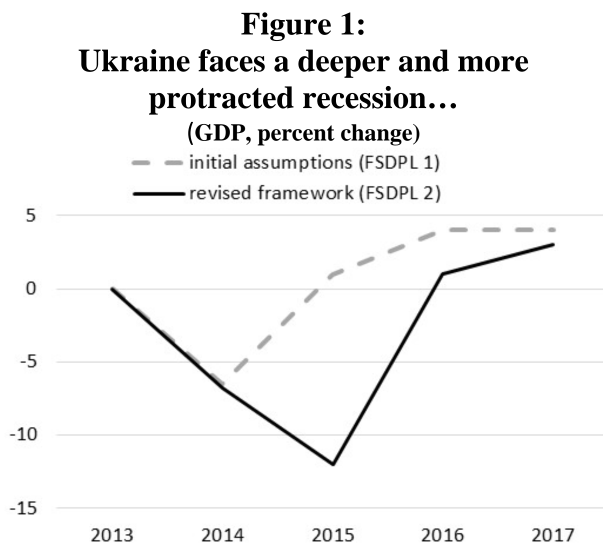


Figure 2:
…accompanied by larger fiscal imbalances...
(General Government and Naftogaz Deficits, Percent of GDP)

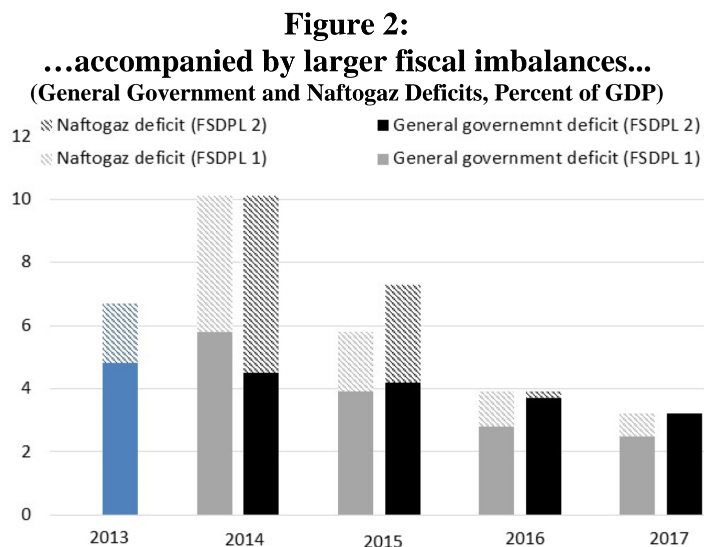


Figure 3:
…higher debt levels…
(PPG, percent of GDP)

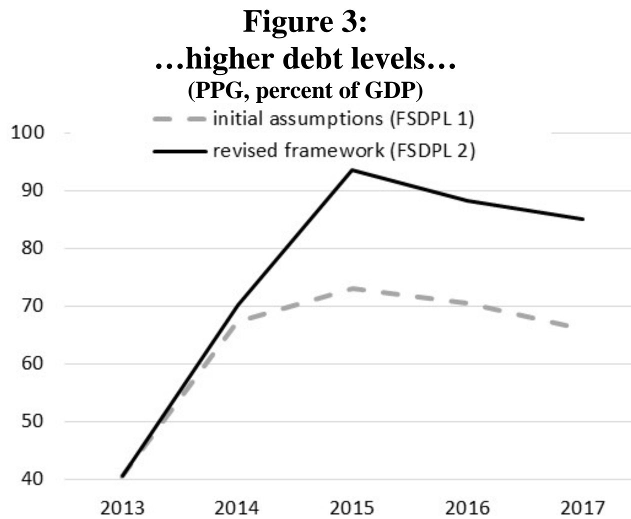
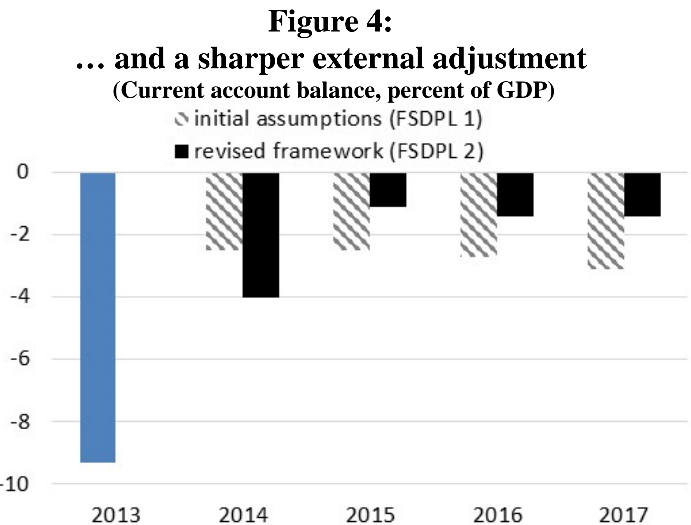


Figure 4:
… and a sharper external adjustment
(Current account balance, percent of GDP)



Source: World Bank staff calculations based on IMF EFF.

15. **While there are some initial signs of stabilization, the macroeconomic environment remains challenging.** The real GDP decline slowed from 17.2 percent y/y in the first quarter of 2015 to 14.7 percent y/y in the second quarter, bringing the average decline during the first half of the year to roughly 16 percent. Inflation reached 55.3 percent y/y in July due to tariff increases for households and large currency depreciation during the first quarter. On the positive side, the budget outturn in the first seven months of 2015 continued to be on track, partly due to high inflation. The foreign exchange market has remained broadly stable since March 2015, largely due to temporary administrative controls put in place in February. Capital flight and deposit outflows subsided. The current account turned positive in the first half of the year as a result of depreciation and foreign investments. This, together with the first IMF EFF disbursement of US$5 billion, allowed for rebuilding of international reserves to US$10.4 billion by end July 2015, although this is still less than 3 months of imports. Subsequently, on July 31, 2015, the IMF Board completed the first review of the EFF, which enabled disbursement of SDR 1.2 billion (about US$1.7 billion), bringing total disbursements under this arrangement to SDR 4.72 billion (about US$6.68 billion). Despite the disbursement of the second EFF tranche, external and public financing risks remain significant, especially in light of the protracted negotiations with creditors on restructuring of Ukraine's sovereign, quasi-sovereign and sovereign-guaranteed debt.

16. **While risks are exceptionally high, the macroeconomic policy framework is adequate for FSDPL2, but hinges on the continued implementation of the Minsk II agreement and the IMF EFF along with the external financing it unlocks.** The macroeconomic framework underpinning this operation is broadly aligned with the policies supported by the IMF EFF, but the projections have been updated based on more recent data.[7] Additional external financial support and policy measures anchored in the four-year IMF EFF are expected to mitigate the impact of macroeconomic shocks. If these policies are consistently implemented and the situation in the east

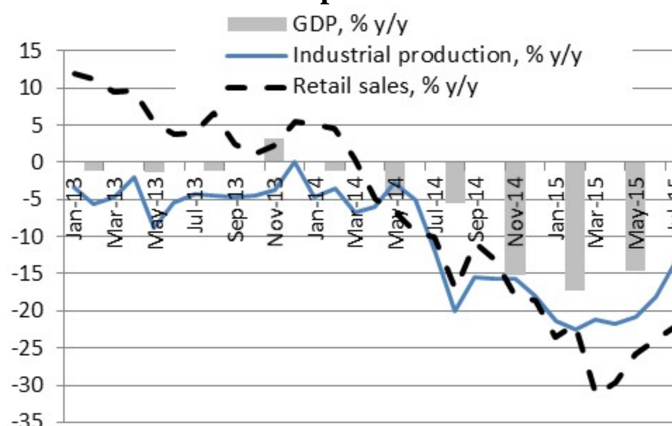
[7] Compared to multi-sector DPL2, approved by the World Bank Board of Executive Directors on August 25, 2015, this program document has been updated to reflect more recent data, including second quarter GDP estimates, released on August 14th. High frequency data confirms that there are some initial signs of stabilization, albeit at a lower level of economic activity than initially envisaged.

does not worsen, there is a good chance that the authorities will succeed in restoring fiscal and external sustainability over the medium term. The macroeconomic framework builds on the policies initiated under the earlier IMF Stand-by Arrangement (SBA), but allows for a longer adjustment period, and unlocks more financial support to fill the larger financing gap. The core elements of the policy framework comprise exchange rate flexibility, monetary policies to contain inflationary pressures, fiscal consolidation, and measures to tackle banking sector risks. Macroeconomic stabilization is underpinned by a comprehensive structural reform program to address the root causes of the current crisis, including measures supported by the two World Bank DPL series. Frontloaded financial support under the IMF EFF to boost reserves is expected to rebuild confidence and stabilize the currency market, while the proposed debt operation would help meet financing needs and enhance debt sustainability.

2.1 RECENT ECONOMIC DEVELOPMENTS

17. **Against the backdrop of ongoing macroeconomic adjustment and the conflict in the east, real GDP declined by an estimated 6.8 percent in 2014 (Table 1).** Investment and consumption contracted due to a rebalancing of the economy, which was compounded by uncertainty weighing on consumer and investor confidence. This was partly offset by a moderate positive contribution of net exports, which was driven by a sharp decline in imports after the depreciation. By sector, the decline was driven by falling industrial production (down 10.1 percent in 2014), transport (freight turnover down 10.7 percent and passenger turnover down 11.5 percent), and wholesale and retail trade (down 17.9 percent and 8.9 percent, respectively) (Figure 5). Output rose only in agriculture (by 2.2 percent). The recession deepened significantly in the second half of the year, after the conflict in the east escalated. The output decline was particularly severe in the regions directly affected by the conflict. Donetsk and Luhansk oblasts account for 83 percent of the overall decline in industrial output, 44 percent of the decline in retail sales, and 66 percent of the decline in exports (Figure 6). The conflict is estimated to account for about 2.5-3 percentage points of the overall GDP decline in 2014 (Box 1).

Figure 5: The intensifying conflict in the second half of 2014 deepened the recession



Source: World Bank staff calculations based on official data.

18. **After deepening during the first quarter of 2015, the recession moderated slightly during the second quarter.** After contracting by 17.2 percent during the first quarter, GDP declined by 14.7 percent in the second quarter, bringing the average for the first half of 2015 to -16 %. The decline was broad-based across all sectors, including agriculture. Industrial production contracted by 20.5 percent in the first half of the year because of the continued conflict in the industrialized east. Meanwhile, macroeconomic adjustment is affecting the rest of the country.

Declining real incomes are weighing on consumption which contracted by 15.4 percent y/y during the first quarter, also reflected in plummeting retail trade which dropped over 25.1 percent y/y during the first half of the year.

Table 1: Key Macroeconomic Indicators

	2013	2014	2015f	2016f	2017f	2018f
Real economy						
Nominal GDP, UAH *billion*	1465.2	1566.7	1957.8	2372.8	2662.3	2961.6
Real GDP, *percent change*	0.0	-6.8	-12.0	1.0	2.0	3.0
Consumption, *percent volume change*	5.2	-7.4	-17.9	-2.0	-0.2	3.1
Investment, *percent volume change*	-8.4	-23.0	-24.6	9.4	13.0	5.9
Exports, *percent volume change*	-8.1	-14.5	-19.8	6.0	5.0	5.1
Imports, *percent volume change*	-3.5	-22.1	-31.7	3.1	4.6	6.5
Unemployment rate (ILO definition), *percent*	7.3	9.3	11.5	11.0	10.5	10.0
GDP deflator, *percent change*	3.1	14.8	42.0	20.0	10.0	8.0
CPI (pa), *percent change*	-0.3	12.1	50.0	23.4	9.9	7.0
CPI (eop), *percent change*	0.5	24.9	50.8	12.2	8.0	5.0
Fiscal Accounts						
Revenues, *percent GDP*	43.6	40.8	40.8	39.7	40.0	40.0
Expenditures, *percent GDP*	48.4	45.4	45.0	43.4	43.1	42.6
General Government Balance, *percent GDP*	-4.8	-4.5	-4.2	-3.7	-3.1	-2.6
General Government and Naftogaz Balance, *percent GDP*	-6.7	-10.1	-7.3	-3.9	-3.1	-2.6
PPG debt (eop), *percent GDP*	40.6	70.3	93.5	88.2	85.1	81.1
Selected Monetary Accounts						
Base Money, *percent change*	20.3	8.5	27.3	17.7	12.4	10.7
Credit to non-government (at program exchange rate), *percent change*	9.5	-15.6	-4.0	10.6	12.0	7.6
Balance of Payments						
Current Account Balance, *percent GDP*	-8.6	-4.0	-1.1	-1.4	-1.4	-1.6
Merchandise Exports, *percent GDP*	34.1	41.6	44.9	39.6	39.0	38.0
Merchandise Imports, *percent GDP*	44.6	46.2	46.9	41.7	41.0	40.3
Foreign Direct Investment, *percent GDP*	2.1	0.2	1.6	1.7	2.0	2.0
Gross Reserves, *billion US$, eop*	20.4	7.5	18.3	22.3	28.5	35.2
In months of next year's imports	*3.3*	*1.8*	*4.3*	*4.9*	*5.7*	*5.9*
Percent of short-term external debt	*33.9*	*13.3*	*35.4*	*44.3*	*50.7*	*60.5*
External Debt, *percent GDP*	78.6	97.6	156.7	143.9	135.7	126.8
Terms of Trade, *percent change*	0.9	2.1	-10.5	-2.6	-0.1	0.0
Exchange Rate, UAH*/US$ (average)*	8.2	12.1	…	…	…	…
Memo:						
Nominal GDP, *US$ billion*	177.4	130.7	…	…	…	…

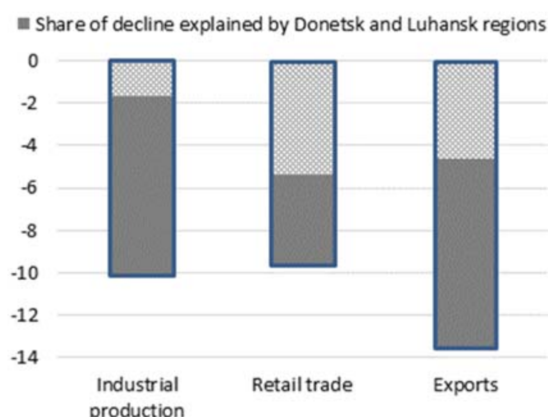
Source: Data through 2014: national data, IMF and World Bank staff estimates.

19. **While economic contraction and the deteriorating situation in the east are putting pressure on fiscal accounts, consolidation measures contained the deficit during 2014 and fiscal performance remained on track during the first half of 2015.** Ukraine entered the current crisis with a large fiscal deficit of 4.8 percent of GDP in 2013. To contain the budget deficit during 2014, the Government adopted two consecutive rounds of fiscal measures in March and July 2014 to boost revenues while curtailing expenditures. These measures included cuts to discretionary spending on subsidies, investment and goods and services, as well as revenue measures to broaden the VAT base, tax rate increases for subsoil exploration and efforts to improve tax compliance. Despite this, revenue performance deteriorated due to sharper economic contraction and difficulty in collecting taxes in the east. Meanwhile, security-related expenditures almost doubled to about 2 percent of GDP, and depreciation increased interest payments by one percentage point to 3.3

percent of GDP. Despite the challenging environment, the general government fiscal deficit slightly improved to 4.5 percent of GDP in 2014 (better than projected at the time of Board approval of the FSDPL1). During the first half of 2015, fiscal performance remained on track because of tight control on expenditures and strong nominal revenue performance bolstered by high inflation.

Box 1: Economic Impact of the Conflict

Figure 6: Conflict region contributed to the overall contraction



Source: World Bank staff estimates based on official statistics.

The conflict exacerbated Ukraine's existing macroeconomic and structural problems making adjustment more difficult. Luhansk and Donetsk oblasts are major industrial centers (including mining and energy production). Before the conflict, they accounted for 15.7 percent of GDP and almost a quarter of Ukraine's industrial production and merchandize exports. The territories not under Ukrainian government control – which are a part of Donetsk and Luhansk oblasts – are estimated to account for about 6-7 percent of GDP. The conflict has wide-ranging *direct and indirect* economic impacts that have undermined the overall macroeconomic situation. Economic activity is severely disrupted by the conflict. Production facilities and economic infrastructure in areas not controlled by the Ukrainian government have been destroyed or severely damaged. Large numbers of people are displaced. Weak revenue collection and security-related expenditure add to the fiscal burden. Uncertainty is further eroding confidence beyond the directly affected areas with negative impacts on investment and consumer spending, which are already battered by the ongoing macroeconomic crisis.

- **Real Sector Impact:** Industrial production in Luhansk and Donetsk oblasts declined by an estimated 42.0 percent and 31.5 percent in 2014 respectively, compared to a decline of 10.1 percent in Ukraine on average. About 78 percent of industrial capacity in Donetsk oblast is currently in the territory not controlled by the Government. In Luhansk oblast, about 84 percent of industrial capacity is currently in the territory not controlled by the Government.
- **Labor Market Impact:** The virtual collapse of production and output in conflicted-affected areas resulted in job losses. Preliminary figures show that reduction in net employment in Donetsk oblast has been around 40 percent and 70 percent in Luhansk oblast. These reductions amount to a total of about 800,000 jobs by end 2014.
- **External Trade Impact:** Exports from the two regions declined by 37 percent, compared to a 13.5 percent overall decline for Ukraine. This is a reflection of disruption to export industries located in the two regions, but also of deeper trade links with the Russian market where substantially weaker demand was compounded by periodic trade restrictions. Meanwhile, because Ukraine's domestic coal is located in the territory not controlled by the Government, coal had to be imported, which added to foreign exchange pressures.
- **Banking Sector Impact:** The crisis intensified pressures in the banking sector. While deposit outflows in 2014 were significant across the country, larger withdrawals were observed in the conflict areas with 57 percent outflow of household deposits in Donetsk oblast and 50.9 percent outflow in Luhansk oblast, compared to an outflow of 24.3 percent in the rest of the country.
- **Fiscal Impact:** Donetsk and Luhansk oblast contribute nearly 22 percent of general government revenues. Budget revenues (excluding the pension fund) in the two regions declined about 53 percent and 35 percent, respectively, in 2014, putting pressure on overall budget performance. Meanwhile, expenditures in the two regions were executed as planned until November when the government suspended spending in the territory not controlled by the Government. At the same time, security-related spending almost doubled to nearly 2 percent of GDP in 2014. In addition, there are rising spending needs to provide for the increasing number of internally displaced people.

20. **Meanwhile, the widening quasi-fiscal deficit of Naftogaz, partly driven by currency depreciation, eroded the overall fiscal position in 2014.** Despite tariff increases supported by the World Bank multi-sector DPL1 and the IMF's SBA, Naftogaz's financial position deteriorated during 2014 due to the increased import price in Hryvnia terms following the devaluation and lower profits from gas sales to industrial consumers because of weak economic activity. The Naftogaz deficit widened to 5.6 percent of GDP, and together with the general government, brought the overall consolidated general government deficit to 10.1 percent of GDP. Government financing to Naftogaz was provided through below-the-line recapitalization bonds (monetized by the National Bank of Ukraine (NBU)), putting pressure on the public debt burden and on foreign exchange reserves.

Figure 7:
Despite the current account adjustment, the balance of payments remains fragile...

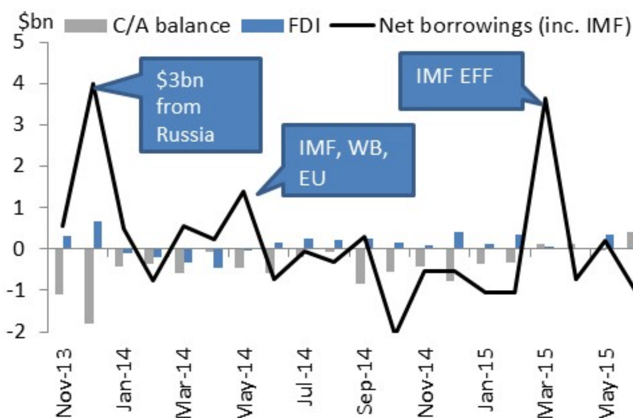
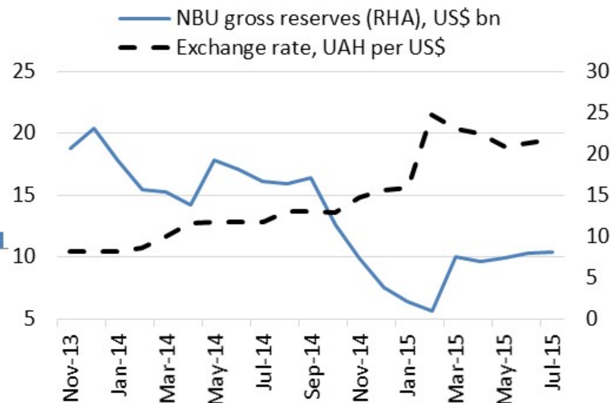


Figure 8:
…putting pressure on the currency and foreign exchange reserves



Source: World Bank staff calculations based on official data.

21. **After losing about 70 percent of its value since the beginning of 2014, the exchange rate has broadly stabilized over recent months.** After the move to a flexible exchange rate in February 2014, the currency remained under acute pressure for most of 2014 and early 2015, aggravated by the fragile balance of payments and loss of confidence. Pressures in the currency market intensified in the fourth quarter of 2014 due to delays in official inflows, dwindling foreign exchange reserves and heightened devaluation expectations, triggering capital outflows which in turn further exacerbated the loss of confidence. Downward pressure continued during first three months of 2015, resulting in cumulative depreciation since January 2014 to close to 70 percent. After periodic interventions by the NBU eroded already low reserves and led to a growing parallel market, the NBU abandoned all interventions in February 2015. The NBU resorted to a number of administrative measures[8] aimed to support foreign exchange supply, curb demand and limit

[8] In 2014, the NBU increased export surrender requirement to 75 percent, reduced the limit for individuals' foreign exchange purchases, banned transfers abroad of proceeds from over the counter sales of securities and dividend repatriation for such securities. In addition, the NBU implemented a list of measures in early 2015: (i) extension of the period local currency intended for foreign exchange purchases needs to be held in Bank deposits from two to three days; (ii) a tax clearance certificate from the State Tax Authority is required for foreign exchange purchases of US$50 thousand and above; (iii) all advanced payments or import contracts over US$0.5 million have to be backed by a letter of credit from an investment grade bank (contracts below this amount

currency speculation. These measures dampened further weakening, and stemmed the outflow of reserves starting in early March (Figure 8). Since then the currency market remained broadly stable, with administrative controls still in place.

22. **Due to depreciation and utility tariff hikes, consumer price inflation has been on the rise.** The twelve-month consumer price inflation rose from near zero in January to 24.9 percent in December 2014 – the highest annual increase since late 2008. After peaking at 60.9 percent y/y in April 2015 (when tariffs were increased), inflation moderated slightly to 55.3 percent y/y in July 2015. To contain inflationary pressures, the NBU implemented consecutive hikes in the refinancing rate, first from 12 percent to 17.5 percent in late 2014 and then to 33 percent in February 2015.

23. **After widening steadily in previous years, the external current account started to adjust, but the impact of currency depreciation was dampened by the conflict.** In 2013, the current account deficit widened to 8.6 percent of GDP as a result of a weak external environment, an overvalued exchange rate and a loose fiscal policy. Currency devaluation following the abandonment of the long-standing de facto peg to the dollar in February 2014, and fiscal tightening, led to an adjustment of the current account deficit. However, the impact of depreciation was dampened by conflict-related disruptions in export-oriented industries in the east, weak external demand, as well as imports of gas and coal (after local coal production was damaged in the conflict areas). As a result, the current account deficit amounted to 4.0 percent GDP in 2014. The external adjustment continued during 2015. In the first half of 2015, the current account balance turned positive, mainly driven by a sharp compression of imports that more than offset the conflict-related drop in exports.

Figure 9:
Persistent deposit outflows…

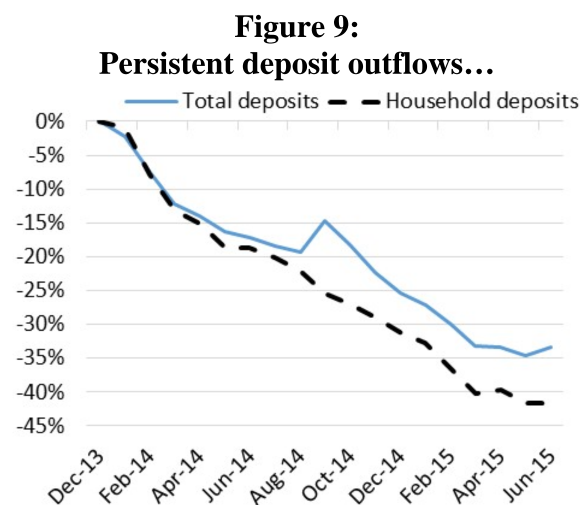
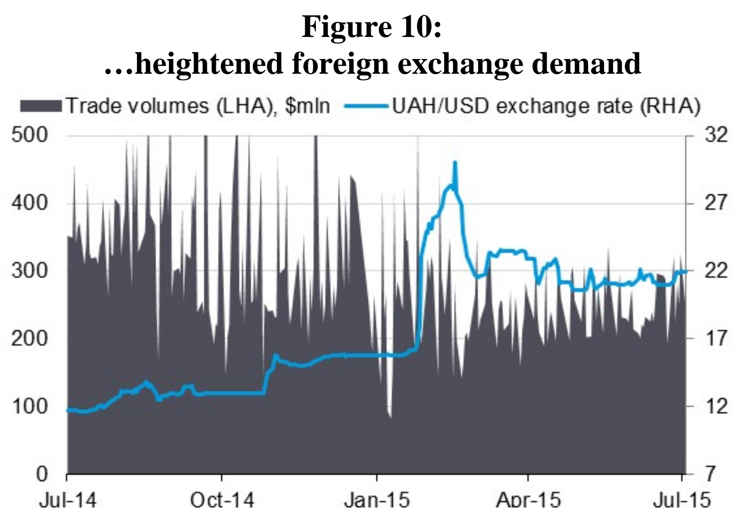


Figure 10:
…heightened foreign exchange demand



Source: World Bank staff estimates.

24. **Despite the current account adjustment, balance of payments pressures intensified in 2014 and remain a concern in 2015.** During 2014, repayments of arrears to Gazprom, increased demand in the cash foreign exchange market stemming from deposit outflows from the banking

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without legitimate letters of credit will be checked by the NBU directly); (iv) banks are not allowed to buy foreign currency for their corporate clients if these companies already have foreign exchange deposits exceeding US$10 thousand.

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system, and delays in official financing negatively affected the financial account. As expected, banking and corporate sector external debt rollover rates declined from 107 percent in 2013 to 85.4 percent in 2014 (slightly lower than the assumption of 89 percent at the time of FSDPL1). Official inflows, including the first tranche of the IMF SBA (US$3.09 billion), DPL1 (US$750 million), and FSDPL1 (US$500 million) helped ease balance of payments pressures. However, delays in the disbursement of the IMF second/third review tranches as well as other official assistance in the second half of the year, coinciding with Eurobond repayments and clearance of payment arrears to Gazprom, put significant pressure on the financial account. Foreign reserves declined to US$7.5 billion (1.4 months of import cover) by the end of the year, and dropped further to US$5.6 billion by end-February 2015. The first tranche of the IMF EFF (about US$5 billion) in mid-March, together with other assistance (including US$1 billion of Eurobond guarantee by the US) allowed for a rebuilding of reserves to around US$10.4 billion by end July 2015 (2.2 months of imports). The first review under the IMF EFF was completed on July 31, 2015. Based on the review, the IMF released the tranche in the amount of US$1.7 billion to the country.

25. **Currency depreciation and economic contraction have put significant stress on the weak banking system.** Since the beginning of 2014, 54 out of 180 banks have failed (including the 4th, 10th, and 17th largest banks by assets) and there are significant risks of additional bank failures. Although UAH-denominated retail deposits showed initial signs of stabilization in June 2015, almost 54 percent of foreign exchange-denominated retail deposits and 29 percent of UAH-denominated retail deposits have left the system since end-2013 to end-June, 2015 (Figure 9), in turn putting pressure on the currency market (Figure 10). Meanwhile, depreciation is also straining the banks' capital adequacy ratio (CAR) through proportionate losses generated from sizable open short foreign exchange positions and deterioration of the loan portfolio, given the large share of foreign exchange denominated loans (54 percent). NPLs have increased from 12.9 percent at end-2013 to 24.3 percent in the second quarter of 2015, with the expectation that they will rise further in the coming months, as the full effect of devaluation, conflict in the east, and the higher than expected economic contraction in 2015 (including a decline in consumption and export demand), will be reflected in asset quality. The losses caused by devaluation and provisioning for bad loans have pushed the system-wide CAR from 18.2 percent at the beginning of 2014 to 9.0 percent in end-June 2015 due to the impact of the exchange rate depreciation, higher NPLs, and increased provisioning.

26. **Exacerbated by persistent fiscal and external imbalances, lower GDP and currency depreciation, public and external debt-to-GDP ratios increased rapidly.** Public debt as a share of GDP increased from 40.6 percent of GDP in 2013 to an estimated 70.3 percent of GDP in 2014. While large net fiscal financing needs to cover the budget and Naftogaz deficits, and support the banking sector contributed to the increase, currency depreciation pushed up foreign exchange denominated public debt (the valuation effect accounts for about 22 percentage points of the overall increase).[9] Meanwhile, external debt increased from 78.6 percent of GDP in 2013 to 97.6 percent of GDP in 2014. Due to the economic contraction and exchange rate depreciation, the dollar value of Ukraine's GDP declined by about 27 percent during 2014 and with it, Ukraine's capacity to service its external debt.

[9] About 56 percent of Ukraine's public and publicly guaranteed (PPG) debt is external. In addition, foreign exchange denominated domestic debt accounts for another 6 percent of the PPG debt stock.

2.2 MACROECONOMIC OUTLOOK AND DEBT SUSTAINABILITY

27. **GDP is expected to contract further in 2015**. We expect real GDP to decline by 12 percent in 2015, with a stronger contraction during the first half of the year, followed by a slowing decline during the second half of the year due to the low statistical base (given the deep decline during the second half of 2014). The decline is expected to be broad based and especially in metals and mining, which are most affected by the conflict. Retail trade is likely to further decline due to a notable drop in real disposable income, triggered by a sharp increase in tariffs, currency depreciation and declining real wages. Problems in the banking sector are expected to continue. Combined with tighter liquidity in line with monetary policy objectives, this will imply further contraction of credit to the economy during 2015. On the external side, the positive impact of depreciation on exports will be undermined by conflict-related disruptions in major export industries and decrease in volume of trade with Russia (traditionally a key export market for Ukraine). At the same time, the contribution of net exports is still expected to be positive due to a sustained contraction of imports.

28. **Economic recovery is likely to set in later than initially projected and to be less pronounced.** If the situation in the east does not deteriorate, a return of positive – albeit low – growth from 2016 onwards is projected to be driven by net exports, investment and privatization. Following four consecutive years of sharp decline, investment is projected to rebound modestly in 2016 from a low base with improving investor sentiment, which will contribute positively to economic growth. Recovery in investment will be underpinned by structural reforms, including those supported by the Bank's multi-sector DPL series, which are expected to boost competiveness and productivity of businesses. Equally, credit growth is expected to resume in 2016 provided that the sector is stabilized and that the authorities follow through on the financial sector reforms needed to create a more vibrant sector going forward, as supported by the FSDPL series.[10] Recovery in consumption is projected to be delayed due to further increases in tariffs, pension freezes, and a slow recovery of the labor market implying subdued real wage growth.

29. **Inflation is expected to pick up during 2015 and remain relatively high in 2016 due to tariff increases.** Period average inflation is expected to rise to 50 percent in 2015 due to depreciation and tariff increases. Tight fiscal policy accompanied by monetary measures, including positive real interest rates and monetary targeting (with targets for base money, net domestic and net foreign assets agreed under EFF) is likely to reduce inflation to 7 percent in 2018. While the NBU remains committed to move to targeting inflation over the medium term, it will require strengthening of the NBU's technical and operational capacity.

30. **The current account deficit is expected to continue to adjust due to the substantial decline in domestic demand engendered by exchange rate adjustment and fiscal consolidation.** The larger external financing needs, higher external debt levels and low reserve position will require a sharper adjustment of the current account (than initially projected at the time of FSDPL1), mainly driven by a significant depreciation of the real exchange rate and administrative measures. While the potential positive impact of depreciation and structural reforms

[10] Despite the nominal rebound shown in 2016 from a very low base, credit growth still remains negative in real terms.

on exports will initially be limited due to sluggish external demand and disruption of economic activity in the east, external adjustment will be driven by imports which are projected to contract significantly. The current account deficit is projected to decline to 1.1 percent of GDP in 2015 and to stabilize at this level to allow for a return to sustainable external debt levels.

Table 2: Balance of Payment Financing Requirements and Sources

	2014	2015f	2016f	2017f	2018f
Financing requirements (US$ billion)	**52.2**	**48.6**	**46.8**	**44.8**	**44.9**
Current account deficit	5.3	1.0	1.4	1.5	2.0
Long-term debt amortization (excl. IMF)	12.5	18.9	16.1	13.2	12.0
Short-term debt amortizations	34.4	28.7	29.3	30.2	31.0
Financing Sources (US$ billion)	**52.2**	**48.6**	**46.8**	**44.8**	**44.9**
FDI and portfolio investments (net)	-2.4	1.5	1.7	2.1	2.4
Long-term debt disbursements (excl. IMF)	11.1	14.8	13.0	12.0	13.7
Short-term debt disbursements	29.7	29.3	30.2	31.0	32.8
Change in reserves	12.9	-10.7	-4.0	-6.3	-6.6
IMF credit (net)	0.9	8.5	2.5	1.6	0.4
Debt operation	0.0	5.2	3.4	4.4	2.3

Source: World Bank staff calculations based on the framework underpinning the IMF EFF and official data.

31. **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).** Capital outflows and erosion of reserves during 2014 together with large debt repayment needs[11] have heightened Ukraine's external financing needs, which are estimated at more than US$40 billion over 2015-2018. Inflows of FDI are expected to remain subdued during the projection period (at about 5 percent of the historical average 2005-2013). The rollover rates of corporate and banking sector debt are assumed to drop to 64.3 percent and 86.6 percent in 2015 and then gradually recover to an average of about 104 percent by 2018.[12] During 2015-16, net outflows in the banking and corporate sector will be partially offset by inflows of official assistance, estimated at about US$25 billion over the next four years, based on current commitments by major partners. Residual financing needs are expected to be covered by the envisaged debt operation, which is estimated to contribute about US$15.3 billion to the overall financing needs. Under the base case, therefore, available external financing is expected to be sufficient to meet balance of payments requirements. Frontloaded disbursements of the IMF EFF and other official inflows, expected to amount to more than US$10 billion in 2015 will allow the NBU to shore up reserves. Going forward, macroeconomic stabilization supported by the IMF EFF and a resolution of the conflict in the east are expected to boost investor confidence and lower costs of external financing. A gradual buildup of international reserves to 5.9 months of imports cover is expected by 2018.

32. **Fiscal consolidation efforts and a recovery in growth are expected to reduce the fiscal deficit over the next three years.** The general government deficit in 2015 is projected to decrease to 4.2 percent of GDP, followed by a progressive, expenditure-led adjustment to 3.1 percent of GDP in 2017. The economic slowdown and the conflict in the east are expected to continue to dampen revenue collection, especially of direct taxes (corporate income tax, personal income tax,

[11] Over the next four years Ukraine's public external debt service payments amount to about a cumulative US$30 billion (including private and official creditors), of which about US$23 billion is for principal repayments. Debt service payments on the IBRD portfolio amount to about US$270 million and US$271 million in 2016 and 2017, respectively.

[12] While the maturity structure of corporate external debt is heavily weighted on the short term (around 32 percent), a large portion is for trade credits, thus limiting rollover risks.

and payroll taxes) while devaluation and inflation will sustain nominal collections of VAT, excises and customs duties, therefore containing overall revenue shortfalls in 2015. On the expenditure side, the amended 2015 budget envisages several measures to structurally reduce the size of the budget footprint, mainly by lowering public consumption and current transfers. Specific measures include steps to address imbalances in the pension system (curtailment of early retirement and special pension benefits), rationalization of public employment to reduce the public sector wage bill, and reduction of subsidies. At the same time, the 2015 budget envisages additional allocation for social assistance spending to mitigate the impact of tariff increases (see below) on the poor and vulnerable.

Table 3: Key Fiscal Indicators
(Percent of GDP)

	2013	2014	2015f	2016f	2017f	2018f
Revenues	**43.6**	**40.8**	**40.8**	**39.7**	**40.0**	**40.0**
Tax revenues	37.9	35.8	35.1	35.7	36.1	36.2
Corporate profit tax	3.8	2.6	2.2	2.2	2.2	2.2
Personal Income tax	5.0	4.8	4.8	5.0	4.9	4.9
Payroll tax	13.3	11.8	9.6	10.1	10.2	10.2
Property tax	0.9	0.8	0.7	0.7	0.7	0.7
VAT	8.8	8.9	9.4	9.6	9.6	9.6
Excises	2.5	2.9	3.3	3.4	3.4	3.4
Taxes on international trade	0.9	0.8	1.8	1.1	1.1	1.0
Other taxes	2.7	3.2	3.3	3.6	4.0	4.2
Non-tax revenues	5.7	5.0	5.7	4.0	3.9	3.8
Expenditures	**48.4**	**45.4**	**45.0**	**43.4**	**43.1**	**42.6**
Current expenditures	46.2	44.3	41.8	40.7	39.6	38.9
Wages and compensation	11.5	10.4	9.2	8.9	8.4	8.4
Goods and services	7.1	7.5	7.4	7.1	7.0	7.0
Interest payments	2.5	3.3	5.3	5.1	4.6	4.2
Subsidies to corporations	2.0	2.4	1.5	1.2	1.2	1.2
Current transfers	23.1	20.7	18.4	18.4	18.4	18.1
Pensions	17.2	15.6	13.1	12.6	12.6	12.6
Unemployment, disability and accident insurance	2.0	1.4	1.3	1.2	1.1	1.1
Social programs	3.9	3.7	4.0	4.6	4.7	4.4
Other current expenditures	0.0	0.0	0.1	0.0	0.0	0.0
Capital expenditures	2.0	1.3	2.4	2.4	2.8	2.8
Reserve fund	0.0	0.0	0.2	0.1	0.4	0.4
Net lending	0.2	-0.2	0.6	0.2	0.3	0.5
General Government Balance	**-4.8**	**-4.5**	**-4.2**	**-3.7**	**-3.1**	**-2.6**
Naftogaz Balance	-1.9	-5.6	-3.1	-0.2	0.0	0.0
General Government and Naftogaz Finacing needs	**6.7**	**10.1**	**7.3**	**3.9**	**3.1**	**2.6**
VAT bonds	0.0	0.5	0.0	0.0	0.0	0.0
Bank Recapitalization Requirements and DGF	0.1	1.7	7.7	0.0	0.0	0.0
Total financing needs	**6.8**	**12.3**	**15.0**	**3.9**	**3.1**	**2.6**

Source: World Bank staff calculations based on the framework underpinning the IMF EFF and official data.

33. **Steep gas and district heating tariff increases are expected to eliminate the quasi-fiscal deficit and financing needs of Naftogaz over the medium term.** As part of the gas sector reform and implementation plan, supported by the Bank's multi-sector DPL series, the authorities

announced significant increases in residential gas and district heating tariffs to overcome financial imbalances in the energy sector: a 285 percent average increase[13] in the gas tariff and 67 percent increase in the district heating tariff in 2015 starting April 1, 2015. Tariff increases are expected to reduce the Naftogaz deficit to 3.1 percent of GDP in 2015. Over the medium term, further scheduled annual increases in gas and district heating tariffs and steps to improve collections under the IMF EFF, including distribution accounts for District Heating companies are expected to gradually eliminate losses of Naftogaz (Table 3).

34. **Meanwhile, banking sector stabilization measures may require significant fiscal resources.** The baseline projections for banking sector expenditures in 2015 presented in table 3 are 7.7 percent of GDP, out of which 2.8 percent has been utilized in the first half of 2015. The 7.7 percent of GDP for 2015 is estimated based on official reported data, and includes a buffer in case of additional small banks failures, or the potential state recapitalization of systemically important banks, and thus the full amount may not be utilized in 2015. In this case, the buffer amount remaining will be transferred to the 2016 baseline projections.

35. **The Debt Sustainability Analysis (DSA) indicates that public and external debt sustainability is subject to high risks.** The baseline DSA projections are consistent with the general macroeconomic framework and take into account: (i) successful implementation of the fiscal adjustment; (ii) stabilization of the exchange rate; (iii) official financing inflows; and (iv) basic parameters of the debt operation agreed under the IMF program (see Paragraph 36).

- **Public Sector DSA:** In the baseline scenario, public debt is expected to continue to increase rapidly from 70.3 percent of GDP in 2014 to 93.5 percent of GDP in 2015, driven mainly by large fiscal financing needs (banking sector and Naftogaz) and GDP decline. As a result of the debt operation, economic recovery, and primary surpluses, it will then steadily decline to 70 percent by 2020. Risks to the base case are high. Exchange rate risks are particularly critical given the large share of foreign exchange denominated debt (about 63 percent of total PPG). A real exchange rate shock[14] could push the PPG debt level almost to 121.5 percent of GDP in 2016. A growth shock[15] would also push PPG debt to over 112.1 percent of GDP in 2017. Under these shock scenarios, debt levels would remain elevated during the projection period (Figure 11). At the same time, a combined macro-fiscal shock[16] increases PPG debt level to over 180 percent of GDP till 2019.
- **External DSA:** In the baseline scenario, total external debt peaks at 156.7 percent of GDP in 2015 due to currency depreciation and GDP decline. Current account adjustment, economic recovery and the debt operation would lead to a steady decline of external debt to 110 percent of GDP by 2020. As with public debt, the external debt trajectory is subject to high risks. The external debt adjustment path is particularly sensitive to exchange rate shocks. A 30 percent real depreciation shock in 2016 would drive debt to about 280 percent of GDP in 2016. Lower

[13] Increase in residential gas tariffs depends on consumption volume (above or below 200 m^3 per month) and the season (heating/non-heating).
[14] Maximum historical movement of the exchange rate and pass-through to inflation with an elasticity of 0.3.
[15] Real GDP growth is reduced by 1 standard deviation for 2 consecutive years; revenue-to-GDP ratio remains the same as in the baseline; level of non-interest expenditures is the same as in the baseline; deterioration in primary balance leads to higher interest rate; decline in growth leads to lower inflation (0.25 percentage points per 1 percentage point decrease in GDP growth).
[16] Shock size and duration based on all macro-fiscal shocks (constant primary balance shock, real GDP growth shock, interest rate shock and real exchange rate shock).

GDP growth (by half a historical standard deviation or 2.5 percentage points), and a non-interest current account shock (one percentage point above the baseline) would keep the external debt to GDP ratio above the 140 percent threshold in the medium term (Figure 12).

36. **Negotiations with private creditors on a debt operation are expected to help restore sustainable debt levels and smooth repayments needs for the period following completion of the EFF.** Given the high debt-to-GDP ratio and significant financing needs related to debt service payments on Ukraine's external public debt, including to private creditors, private sector involvement is critical to the sustainability of debt levels. The objectives of the debt operation are threefold: (i) to generate US$15.3 billion savings in the public sector during the program period; (ii) to enhance debt sustainability by bringing the PPG-debt-to-GDP ratio to under 71 percent of GDP; and (iii) to keep gross financing needs of the government after completion of the IMF EFF below 12 percent of GDP a year with a four-year average of 10 percent of GDP. The debt subject to restructuring comprises: sovereign Eurobonds (US$16.8 billion); quasi-sovereign guaranteed Eurobonds (US$1.8 billion); sovereign guaranteed commercial loans (US$0.7 billion); and non-guaranteed state-owned enterprises' (SOE) liabilities (US$3.4 billion). This amounts to US$22.7 billion of debt to be restructured to generate US$15.3 billion in savings during the IMF Program period (2015-2018) and includes both principal and interest payments. Some progress has been made in the negotiations with creditors with the recent signing of the confidentiality agreement.

Figure 11:
Public and Publically Guaranteed Debt Dynamics
(percent of GDP)

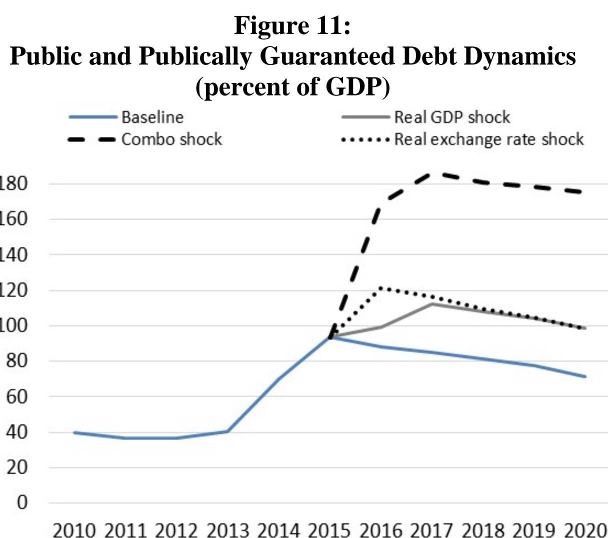
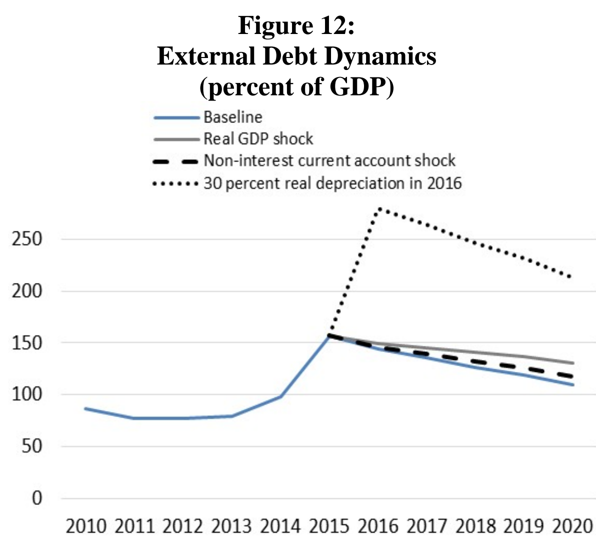


Figure 12:
External Debt Dynamics
(percent of GDP)



Source: World Bank staff estimates.

37. **Risks to the macroeconomic framework are high and cannot be fully mitigated.** While policy measures together with increased external support enhance the prospects of resolving the economic crisis, risks are high and mutually reinforcing:

- *First*, while the macroeconomic policy framework could likely absorb additional moderate domestic and external shocks, resumption, escalation, or both of the conflict would undermine confidence-building measures by the authorities, aggravate output losses, and derail overall stabilization efforts. Moreover, prolonged geopolitical tensions and trade-related disputes with Russia could also hamper the recovery, given the importance of the

Russian market and the difficulty of substituting this export market in the short run.

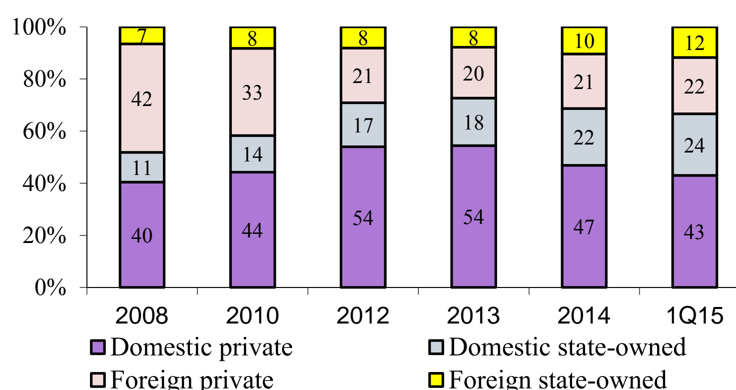
- *Second,* a deeper contraction in 2015 and a more sluggish recovery in the outer years – stemming from lower domestic and external demand – would complicate fiscal and external adjustment. The rebound of investment, which is expected to lead the recovery, could be delayed in case political and economic uncertainties prevail. Moreover, the projected recovery in credit to the economy in 2016 may not materialize in view of the protracted banking sector crisis, thus tempering the projected recovery in investment. Consumption may also remain subdued due to the continued need for fiscal adjustment and a slower recovery in the labor market. The recovery of exports may be hampered by weak external demand and further disruptions in export industries located in the east.
- *Third,* if efforts to regain confidence fail and currency pressures remerge, Ukraine could again get caught in a predicament of mutually reinforcing depreciation, capital flight and inflation in turn aggravating the banking crisis and hampering efforts to restore external and fiscal sustainability.
- *Fourth*, risks to external and fiscal financing are significant. Failure to reach agreements with private creditors, consistent with the assumptions underlying the baseline macroeconomic framework would exacerbate external liquidity constraints, especially in 2016-17, when official inflows are expected to subside. Given the size of the expected private sector contribution to the overall financing requirements, negotiations of the debt operation are complicated. While a successful resolution of Ukraine's private creditor debt may be in the interest of bond holders, holdout creditors could complicate efforts to reach an agreement. As a result, private creditor participation and the terms they are willing to accept could fall short of the targeted contribution. In addition, continued capital flight, lower than expected FDI, and lower rollover rates of corporate and banking sector credit would imply a larger financing gap or a sharper adjustment. Shortfalls and/or delays in official financing due to slippages in macroeconomic and structural reforms could reduce external official assistance and complicate efforts to finance current account and fiscal deficits.
- *Fifth,* efforts to restore sustainable public finances could prove to be more challenging than expected. The economic downturn and conflict in the east could undermine revenue performance despite policy changes and efforts to improve tax administration. Also, austerity measures could encounter resistance and kindle further unrest. Pressures are exacerbated by the Naftogaz deficit and the fiscal financing needed to stabilize the banking sector – both major fiscal risks. While the government has committed to reducing the Naftogaz deficit, the complex nature of the problem, the size of adjustment, and the political economy could make this challenging, especially in the short to medium term. While tariff increases are substantial, a possible fall in collection rates could temper the impact on the Naftogaz deficit. Fiscal risks associated with the banking sector crisis are mitigated by a significant financial buffer built into the baseline framework.
- *Sixth,* broader loss of confidence in the banking sector could trigger a deposit run which would further aggravate instability in the banking sector and potentially increase pressure on the exchange rate. Problems in the financial sector could in turn create a vicious circle between initial macroeconomic shocks, balance sheet problems in banks, and instability and liquidity in financial markets, which could then deepen the economic downturn and increase the burden on the budget. The current macroeconomic crisis has already exacerbated risks in the banking sector, as the currency depreciation is putting pressure on

banks' capital through losses generated from open short foreign exchange positions and an increase in already high NPLs. The deterioration in capital adequacy in turn is likely to force banks to make adjustments in their lending standards, and the ensuing credit crunch would further weaken investment and spending, thus amplifying the economic downturn. This risk is partially mitigated by measures taken by the authorities to bolster confidence and resolve underlying risks in the banking sector that are supported by this FSDPL series, including conducting diagnostic audits of the largest banks to ensure that they are adequately capitalized, reducing the levels of related-party lending in the banking system, and enhancing the capacity of the DGF.

2.3 RECENT BANKING SECTOR DEVELOPMENTS

38. **The banking sector entered the current crisis with significant weaknesses that were not addressed during the 2008-09 crisis.** The 2008-09 crisis hit the banking sector particularly hard. Although confidence in the banking sector was restored by 2010, the authorities failed to address deep-seated banking sector vulnerabilities – high level of NPLs, weak corporate governance, high levels of related-party lending, and ineffective banking supervision. In addition, the banks that were recapitalized using state funds during the 2008-09 crisis were not properly managed, and in some cases, were sold to private owners with political connections. While the system showed modest profitability during 2010-2013, NPLs remained high and credit growth remained lower than before the 2008-09 crisis (Table 4). Citing difficult operating conditions and encountering heavy losses, a number of foreign banks (including Commerzbank, Swedbank, SEB, Erste, and the Bank of Cyprus) exited Ukraine, and the share of foreign banks declined from 42 percent at end-2008 to 20 percent at end-2013 (Figure 13).

Figure 13: Asset Shares by Groups of Banks, percent, 2008-2015:Q1



Source: NBU

39. **The relatively weak condition of the banking sector entering the current crisis has compounded the impact of the sharp depreciation of the local currency, deteriorating economic conditions and conflict in the east.** Confidence in the banking sector has suffered, causing significant deposit outflows. 52 percent of foreign exchange-denominated deposits and 29 percent of Hryvnia-denominated deposits have left the banking system since from January 2014 to June 2015 (Figures 14 and 15). The deposit outflows were particularly heavy in the conflict-affected areas within Luhansk and Donetsk oblasts. The deposit outflow was also triggered by the failure of 54 banks, which accounted for 24 percent of total retail deposits as of April 1, 2014. In recent months, Hryvnia-denominated deposits have stabilized but outflows of foreign exchange deposits have continued. In an effort to support banks suffering from deposit outflows, the NBU increased net refinancing loans to banks by UAH 63 billion to UAH 146 billion during early 2014 to end-April 2015. While this helped to support the banking sector during the crisis, it indirectly added to pressure on the currency.

Figure 14. Change in Banking System Deposits, (percent change fixed exchange rate)

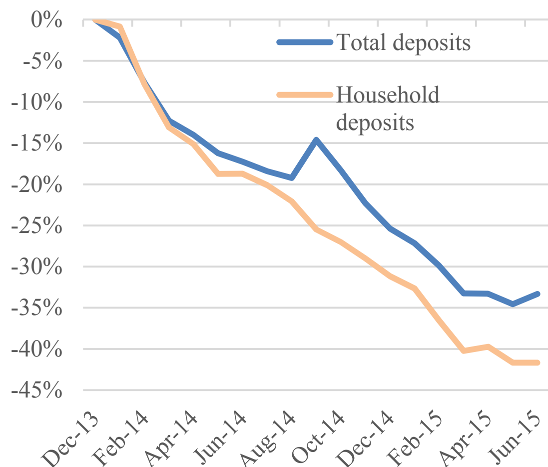
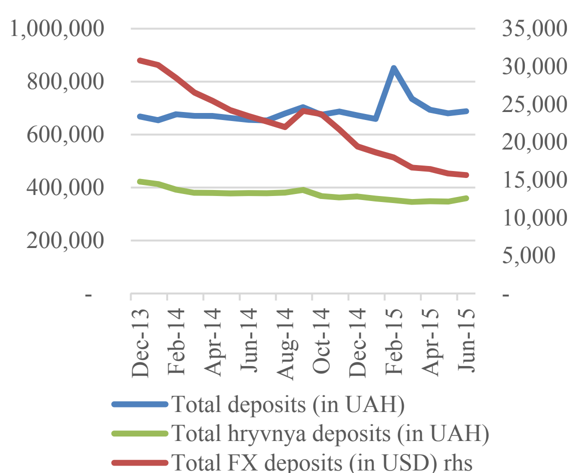
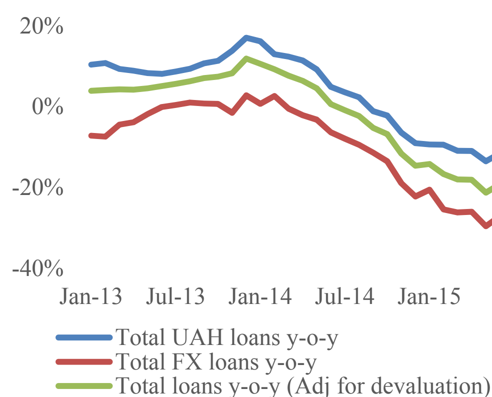


Figure 15. Banking System Deposits, (millions)



40. **As banks have come under pressure, credit has contracted sharply (Figure 16).** The rapid outflow of deposits since 2014 has exceeded the pace of deleveraging in the banking system. This caused an increase in the loan to deposit ratio to 1.35 in June 2015 from 1.26 in early 2014. Most of the loans (46 percent as of the end of the first quarter of 2015 and 51 percent as of January 2014) are of short-term maturity under one year, and only 13 percent of loans have maturities higher than 5 years.

Figure 16: Change in Banking System Credit, 2013-15 (percent year over year)



Source: NBU

41. **Non-performing loans have also increased, while capital adequacy and profitability has declined.** The level of NPLs increased from 12.9 percent at end-December 2013 to 24.3 percent at end-June 2015[17] (Table 4). These are expected to continue rising in coming months as losses stemming from currency depreciation and the situation in the east are taken into account. The banking sector is currently unprofitable as a whole, with annualized Return on Assets (ROA) and Return on Equity (ROE) at -11.7 percent and -157.9 percent in June 2015 (Table 4). The CAR of the banking sector has been declining, and fell to 9.0 percent in June 2015 (Table 4).

[17] According to the NBU methodology (which classifies NPLs as category IV and V only) NPLs to total loans stood at 24.3 percent at the end of June, 2015. However, under the broad definition (III+IV+V categories), the levels of NPLs in the country are much higher than officially reported, and are estimated at 39.7 percent.

Table 4: Key Banking Sector Indicators, Percent, 2007-2015

	2007	2008	2009	2010	2011	2012	2013	2014	end-June 2015
Assets/GDP (percent)	84.1	97.5	96.4	86.1	81.0	80.0	87.8	85.2	-
Loans/GDP (percent)	68.1	83.4	81.8	69.0	63.4	57.9	62.6	65.9	-
Customer deposits/GDP (percent)	38.9	37.7	35.8	38.1	37.3	40.6	46.5	43.3	-
Loans/Deposits	1.48	1.98	2.07	1.61	1.48	1.32	1.26	1.39	1.35
Share of foreign exchange loans (percent)	51.8	60.7	52.9	48.4	42.2	37.6	35	47.2	53.7
Share of foreign exchange deposits (percent)	32.1	44.0	47.0	44.1	43.3	45.2	38.5	47.9	48.7
NPLs/total loans (percent)		3.8	13.1	14.9	14.3	12.5	12.9	19.0	24.3
ROA (percent)	1.5	1.0	-4.4	-1.5	-0.8	0.5	0.1	-4.1	-11.7 *
ROE (percent)	12.7	8.5	-32.5	-10.2	-5.3	3.0	0.8	-30.5	-157.9 *
CAR (percent)	13.9	14.0	18.1	20.8	18.9	18.1	18.3	15.6	9.0

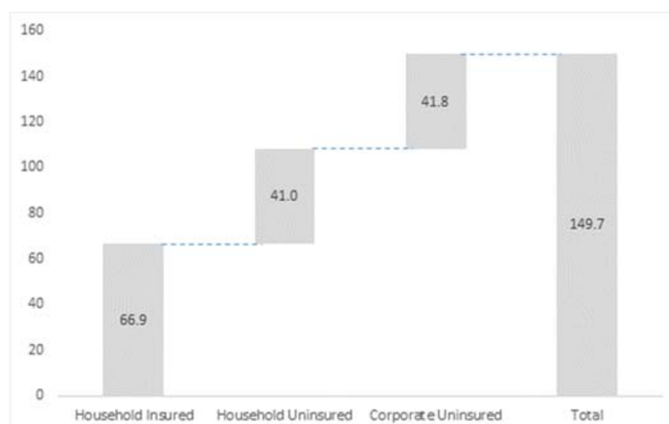
* annualized
Source: NBU

42. **In early 2014 the authorities began to aggressively deal with the liquidity challenge. To ensure solvency of the system, a diagnostic and recapitalization process was launched.** To ensure that the banking sector had enough liquidity to function, the NBU expanded the range and volume of liquidity instruments, and sought to improve the transparency of its decision making process. The NBU also strengthened the supervision of banks by introducing additional measures to better identify and resolve banks as they became problematic. To ensure that the system was adequately capitalized and resilient to shocks, an independent diagnostic of the top 35 banks was launched in mid-2014.

43. **The independent diagnostic studies of the 35 banks found 18 to be undercapitalized.** Out of the 18 undercapitalized banks, 13 were able to satisfactorily implement recapitalization and restructuring plans. The remaining 5 were transferred to DGF for resolution, as they were unable to agree to or complete recapitalization and restructuring plans.

44. **In addition, 49 other banks (in addition to the 5 that were resolved as part of the diagnostic process) were transferred to the DGF for resolution following increased vigilance by the NBU.** The NBU revised the framework for identifying problem banks and for taking enforcement action. This, combined with the overall pressures on the banking system, has resulted in transferring 33 banks to the DGF for resolution in 2014 and another 21 banks since the beginning of 2015. These 54 banks accounted for approximately 21 percent of total banking sector assets, and held about 24 percent of total retail deposits as of April 2014.

Figure 17: Distribution of Deposits in Banks Transferred to the DGF as of July 27, 2014, in billion UAH



Source: DGF

45. **The authorities have not used public funds to recapitalize private banks to date, with the cost of bank failures being primarily borne by owners and creditors of the failed banks**. During the initial stages of the crisis, the authorities developed a strategy that focused on minimizing fiscal costs while maintaining financial stability. Following the experiences from the 2008-09 crisis, during which some banks were recapitalized at significant expense to the state, the authorities determined that all failed banks − except for a select few that could pose financial stability concerns − would be transferred to the DGF for resolution. This strict criteria and methodology for utilizing public funds for private bank recapitalization was established in an "Anti-Crisis Law", and the government has decided not to recapitalize any banks to date after determining that none posed financial stability concerns. Thus all 54 banks resolved from beginning of 2014 up to end-July, 2015 were resolved via the DGF, despite significant political pressure from many of the owners to provide public funds for recapitalizing private banks or to delay action. However, this strategy caused uninsured households and corporate depositors to experience significant losses. The 54 banks that have been transferred to the DGF had a total of UAH 66.9 billion in insured household deposits, UAH 41.0 billion in uninsured household deposits and UAH 41.8 billion in uninsured corporate deposits (Figure 17).

46. **Based on this strategy, the fiscal costs to date of the banking crisis in Ukraine have been relatively moderate compared to other countries (Box 2).** Fiscal costs for the banking sector stabilization fall into three categories: (i) backup funding to the DGF to ensure sufficient liquidity to cover payouts to insured depositors; (ii) recapitalization of state-owned banks; and (iii) recapitalization by the state of systemically important banks. The total fiscal resources spent on the banking sector were 1.7 percent of GDP in 2014 and 2.8 percent of GDP during the first half of 2015 (which was only utilized for backup funding for the DGF and the recapitalization of state-owned banks, as no private banks have been recapitalized using public funds). The baseline projections for banking sector expenditures in 2015 presented in table 3 are 7.7 percent of GDP, out of which 2.8 percent has been utilized in the first half of 2015. The 7.7 percent of GDP for 2015 is estimated based on official reported data, and includes a buffer in case of additional small banks failures, or the potential state recapitalization of systemically important banks, and thus the full amount may not be utilized in 2015. In this case, the buffer amount remaining will be transferred to the 2016 baseline projections.

Table 5: Fiscal Expenditure on Bank Recapitalization and DGF, 2014 – First Half, 2015

	2014		First Half, 2015	
	UAH billion	*% GDP*	*UAH billion*	*% GDP*
DGF backup funding	10.1	0.6	52.8	2.6[18]
State recapitalization of public banks	16.6	1.1	3.2	0.2
State recapitalization of private banks	0	0	0	0.0
Total	26.7	1.7	56.0	2.8

Box 2: International Comparisons of the Fiscal Costs of the Banking Crisis

As a result of the prudent approach taken by the authorities, the fiscal costs of the Ukrainian banking crisis have been low by international comparison to date, even if there are no obvious parallels. The Ukrainian case is characterized by a change of political power, geopolitical tensions, endemic corruption, weak judiciary, large macroeconomic shocks, weak fiscal situation, limited external borrowing capacity, and significant pressures on the exchange rate. The banking system consists of a large number of banks, with the majority of them being "pocket banks", wide-spread connected lending, politically powerful owners, lack of equity capital and a weak supervisory regime. No other banking crisis combines all these characteristics. The closest cases are probably Indonesia and Korea, both in 1997-98 with fiscal costs estimated at 57 percent and 31 percent of GDP respectively. Other comparators could be Argentina (1980) and Venezuela (1994) at 55 percent and 15 percent of GDP respectively. The total estimated fiscal cost of the banking crisis in Ukraine in the baseline projection is 9.5 percent of GDP in 2014 and 2015. This relatively low number is due to the authorities' efforts to minimize the fiscal costs, as the owners and creditors have borne the majority of losses in the banks have been resolved. However, the fiscal costs could increase if there are a large number of small and medium bank failures, if the recapitalization requirements of public banks are larger than expected, or due to a systemic bank failure.

47. **The government has further strengthened the DGF to effectively handle the 54 banks that have been closed since January 2014.** It is important to note that the DGF had experience resolving only two small banks prior to January 2014. The current crisis has greatly increased its workload, and the authorities have focused on strengthening the DGF's financial and operational capacity to enable it to meet its legal obligation to cover household depositors for up to UAH 200,000. A back-up funding mechanism was put in place to ensure that the DGF has adequate financial capacity to reimburse insured depositors, as premiums were no longer sufficient in a crisis situation. Legal changes were also enacted to increase the efficiency of resolving banks, reimburse insured depositors and recover assets from banks in liquidation.

48. **The authorities have taken steps to address endemic corruption in the banking system.** Recognizing that failures of many of the banks were caused by high levels of related-party lending, and outright fraud in some cases, the authorities have taken corrective actions. A revised set of laws on related-party lending and criminalization of fraudulent activities causing bank failures (including significant jail time) was passed in March 2015. These actions required significant political willingness to tackle the entrenched corruption and connections between the political elite and the banking sector that have plagued the system for years.

[18] The total backup funding needed to reimburse insured depositors from the banks that have failed to date is 2.6% of GDP in 2015. However, in the first half of 2015, the actual amount transferred to the DGF was 0.7 percent. Thus they will need 1.9% to pay out the remaining depositors from the 54 failed banks.

49. **In spite of the significant actions taken by the authorities, the banking sector will require additional capital and two additional diagnostic assessments are underway.** Although the largest domestic banks have implemented recapitalization and restructuring programs based on the independent diagnostic studies conducted in mid-2014, there are concerns about asset quality and related-party lending in these banks. To address this, the NBU initiated an updated diagnostic review of the top 20 banks. The review will reflect the situation in the east, depreciation of the Hryvnia, and deterioration in the overall economy since the first diagnostic was completed. Recent bank failures revealed high levels of related-party lending and raised concerns about other banks operating in Ukraine. The NBU has initiated a review of related-party lending in all of the banks operating in Ukraine, with an initial focus on the top 10 domestic banks. Based on the findings, banks will have to unwind related-party lending exceeding regulatory norms as per revised legal framework. These two diagnostic reviews will help to ensure that the largest banks are adequately capitalized and resilient to shocks going forward.

50. **Large systemic banks may pose risks going forward.** Considering the systemic nature of some large domestic banks and the political influence of the owners, the authorities will face significant challenges in ensuring that proper actions are taken in case owners are unwilling or unable to recapitalize or restructure their banks based on the upcoming diagnostic reviews. To mitigate against this risk, the authorities have put in place a legal framework for resolving systemic banks in a manner that maintains financial stability and minimizes the fiscal costs. Fiscal resources to deal with possible systemic bank failures have been included as part of a buffer in the baseline fiscal projections for 2015 (Table 3). This buffer is based on official reported information on the banking sector. In addition to large systemic banks, the authorities could face challenges if a large number of small and medium banks fail, as this could also threaten financial stability, require additional fiscal resources, and further strain the operational capacity of the DGF.

2.4 IMF RELATIONS

51. **The IMF Board of Executive Directors approved a four-year EFF for Ukraine on March 11, 2015, which replaces the Stand-By-Arrangement from April 2014.** The EFF, approved under the IMF's exceptional access policy, is for SDR 12.348 billion (about US$17.5 billion, 900 percent of quota). With Board approval, SDR 3.546 billion (about US$5 billion) was immediately disbursed, with SDR 1.915 billion (about US$2.7 billion) allocated to budget support. Further disbursements will be based on quarterly reviews. IMF's disbursements under the EFF are frontloaded, with SDR7 billion (US$10 billion) expected to be disbursed in 2015, provided the quarterly reviews are completed. In addition to the extended program period, the EFF also extended the repayment period to 2028, increasing expected net disbursement while containing gross financing needs. On July 31, the IMF Board completed the first review of the EFF, which enabled disbursement of SDR 1,182.1 million (about US$1.7 billion), bringing total disbursements so far under this arrangement to SDR 4.72 billion (about US$6.68 billion).

52. **The proposed operation is complementary to the financial sector policies outlined in the IMF EFF.** The World Bank and IMF have worked together to support the authorities in implementing their financial sector reform program and to ensure consistency between the two programs. In particular, the World Bank and IMF have supported complementary actions to strengthen the DGF, ensure adequate capitalization of the largest banks in the country, and build a

healthier and more viable banking system.

3. THE GOVERNMENT'S PROGRAM

53. **The authorities have put in place a program to stabilize the banking system and resume sustainable financial intermediation in the medium term.** The authorities have a two-pronged strategy for the financial sector: short-term stabilization and medium to longer-term resumption of healthy financial intermediation. Given the current political and macroeconomic pressures, the immediate objective is to restore and maintain public confidence and preserve the stability of the banking sector. At the same time, the authorities are committed to pursuing supervisory and regulatory actions that will result in a more resilient banking sector, better incentives to increase domestic savings, and restart the credit flow to the real sector to ensure sustainable growth in the medium to long term. 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).

54. **The authorities' banking sector program focuses on three areas:**

(i) Strengthening the financial and operational capacity of the DGF;
(ii) Ensuring that the largest banks are adequately capitalized;
(iii) Improving the resiliency and efficiency of the banking system

Within each of these three areas, the authorities have made significant progress since the onset of the crisis. However, given the depth of the current crisis, significant risks in the financial sector remain that will require implementation of a longer-term government program in each of these three areas. The progress made in each of the three elements of the government's program is outlined below, along with the plans going forward.

(i) Strengthening the financial and operational capacity of the DGF

55. **Considering the large number of banks that have failed since early 2014 and the potential for more failures, the authorities have strengthened the DGF's financial and operational capacity.** The DGF's regular premium income is insufficient to meet its obligations to insured depositors under the current crisis conditions. Therefore, the government has put in place a mechanism for obtaining back-up funding and has provided the resources necessary to reimburse insured depositors from the banks that have failed to date. The legal framework for the DGF has also been strengthened as critical legal changes have been enacted to speed up the insured deposit reimbursement process and to improve the efficiency of asset recovery from the banks that are being liquidated.

56. **Now that the legal framework for the DGF has been improved, the authorities are planning to focus on utilizing the new tools available to improve the performance of the DGF.** In the months ahead, the DGF will continue to face immense challenges related to resolving banks that have failed and recovering assets from banks that are being liquidated. Although the legal framework for speedy reimbursement of insured depositors and recovering assets has been put in place, the authorities will need to utilize these new powers to improve operational capacity of the DGF to meet its responsibilities related to insured depositor reimbursement and asset recovery.

(ii) Ensuring that the largest banks are adequately capitalized

57. **At the onset of the crisis, the authorities implemented a process to ensure the adequate capitalization of the largest banks in the system and to ensure their resilience to shocks.** The authorities conducted independent bank diagnostics in mid-2014 of the largest banks in the country (the top 35) to ensure that they were adequately capitalized based on various stress test scenarios. These diagnostics resulted in finding that 18 of the top 35 banks required additional capital. 13 of these banks have implemented recapitalization and restructuring plans, and 5 were unable to agree to or implement recapitalization plans and have been transferred to the DGF for resolution. In addition to these 5, 4 other banks within the top 35 that underwent the diagnostic were closed following enhanced supervisory and enforcement actions by the NBU.

58. **The worsening conditions in the country have required the NBU to update the diagnostic studies and subsequent recapitalization and restructuring programs for the largest banks in the country.** After implementing the bank recapitalization and restructuring program based on the 2014 diagnostic studies, the authorities are now conducting a new round of diagnostic studies for the top 20 banks. The studies will include a detailed asset quality review and stress tests that account for worsening conditions in Ukraine. Based on the results, banks will be required to submit credible recapitalization plans. Because of the worsening conditions, the NBU has agreed to ease capital requirements for undercapitalized banks identified by the new diagnostics. The minimum capital requirement will be 5 percent within six months after the recapitalization plans have been agreed to by the NBU, and gradually restored to 10 percent by end-2018. Banks that are unwilling or unable to implement adequate recapitalization will be resolved.

59. **The authorities remain committed to ensuring that public resources for recapitalizing banks are limited only to systemically important banks.** A major challenge going forward will be to ensure that authorities have accurate information about the top banks, and in particular about those that could pose a systemic threat. The new diagnostic process will ensure that this information is available, but the authorities will still face challenges if the owners of these banks are unwilling or unable to develop and implement a credible recapitalization and restructuring plan. To date, the government has not used public resources for private bank recapitalization as it was determined that none of the banks that failed (including the fourth largest bank by assets in the country) posed significant systemic risks to financial stability. The authorities are committed to limiting the use of public resources for bank recapitalization going forward and a mechanism for state recapitalization is included in the Law "On Measures to Promote the Capitalization and Restructuring of Banks". It also includes strict eligibility criteria that are intended to minimize the use of public funds to only those banks that pose systemic risks to financial stability.

(iii) Improving the resiliency and efficiency of the banking system

60. **While the authorities are primarily focused on ensuring the stability of the banking sector in the short term, they have also put in place a program to help resume sustainable financial intermediation in the medium to longer term.** The primary focus of this program is to decrease the level of related-party lending in the system. In addition, measures are being taken to enhance supervision, increase coordination among financial safety net providers, and reduce the level of NPLs.

61. **The NBU has improved supervision of the banking sector.** Many of the weaknesses in the banking sector emerged from poor oversight of the banks that operated in Ukraine. The NBU has improved the process for identifying problem banks and enforcing violations, and bolstered the operational capacity of the banking supervision and licensing departments. Considering the importance of the largest and most systemic banks operating in Ukraine, the NBU has enhanced supervisory and regulatory requirements for systemic banks.

62. **A Financial Stability Council has been created to improve coordination among the financial sector regulators in order to ensure early identification, and minimize risks threatening the stability of the financial system.** In order to deal with insufficient coordination across key decision makers, the authorities have put in place a Financial Stability Council that meets on a quarterly basis and which follows best international practices.

63. **The authorities have made significant progress addressing high levels of related-party lending in the system.** To this end, the banking law and associated regulations have been amended to broaden the definition and to increase the penalties for unlawful activities that cause bank failure. The changes broadened the definition of bank related parties and increased accountability for violations, including criminal charges in cases where a bank was brought to insolvency by unlawful actions of bank managers and owners. To further enhance NBU enforcement practices, the legislative amendments also provided the NBU with new powers to presume the existence of economic and other relations between banks and borrowers on the basis of objective criteria.

64. **The NBU will use the revised legal framework to review the level of related-party lending in the system with the aim to reduce the level over time**. The NBU will be reviewing the level of related-party lending in each of the banks using the new methodology and legal framework, and will initially focus on a review of the top 10 banks with the assistance of international accounting firms. Based on these results, banks with levels of related-party lending above the regulatory norms will be required to develop credible unwinding plans for approval by the NBU. Banks will be resolved if credible unwinding plans cannot be agreed to, or if the implementation of the unwinding plan is breached. The NBU is also strengthening its capacity (and ability) to supervise related-party lending and is establishing a specialized group to support these efforts.

65. **The authorities are developing a comprehensive strategy for assisting banks in resolving NPLs.** Considering the high level of NPLs that already exist in the system and the likelihood that this level will increase in the coming months, a key priority for the authorities is to identify a set of reforms in order to improve bank balance sheets. These reform priorities include legislative modifications, such as the bankruptcy and tax framework, and development of an out-of-court restructuring system. Cleaning up bank balance sheets will be critical to increasing the availability of credit to the economy, which has declined rapidly since the onset of the crisis in January, 2014 (the most recent data from June, 2015 showed a decline of about 20 percent for household and corporate loans compared to the previous year).[19]

66. **Although progress has been made to improve the supervisory capacity of the NBU, the authorities recognize that much more needs to be done.** An overall strategy has been

[19] This includes both foreign exchange loans adjusted for the devaluation and local currency loans

developed for the NBU, and includes plans to improve the human resource capacity of the NBU, create specialized units focused on critical missing functions such as IT supervision and related-party lending supervision, and shifts the responsibility of the majority of Non-Bank Financial Institutions (NBFI) supervision to the NBU.

Financial Sector Reform program going forward

67. **Although significant progress has been made in implementing the financial sector reform program, additional efforts will be needed in each of the three major elements of the program.** These priorities are outlined in paragraphs 56, 58, 64, 65, and 66 and focus on; (i) continuing to strengthen the operational capacity of the DGF (paragraph 56); (ii) implementing the recapitalization requirements of the updated diagnostic studies of the top 20 banks (paragraph 58); and (iii) improving the resiliency and efficiency of the banking sector by completing a related-party lending diagnostic review (paragraph 64), implementing reforms to facilitate the reduction of NPLs (paragraph 65), and improving supervision of the financial system (paragraph 66).

68. **The authorities have a well-articulated vision for the banking sector following the crisis stabilization program and implementation of the medium to long-term financial sector reforms.** Considering the large number of small weak banks in the financial system, the authorities are focused on building a stronger and more consolidated banking sector. The vision of the banking system articulated by the authorities following the implementation of the crisis stabilization and medium to longer-term reform program includes a much smaller number of healthy and viable banks (compared to the 180 that existed prior to the current crisis) that are better supervised. In addition, the authorities envision a deepening of the financial sector by further developing the NBFI sector (with a particular focus on insurance and capital markets).

4. THE PROPOSED OPERATION

4.1 LINK TO GOVERNMENT PROGRAM AND OPERATION DESCRIPTION

69. **The FSDPL series aims to support the authorities in their efforts to deal with the current crisis and undertake reforms to strengthen the banking system.** The series is anchored in three pillars to support the authorities' reform program in the financial sector. Pillar 1 focuses on strengthening the capacity of the DGF to ensure that it can adequately perform its critical bank resolution and insured deposit payout function. Pillar 2 focuses on ensuring that adequate solvency of the banking system is maintained through implementation of bank-specific recapitalization/restructuring plans and timely enforcement action. Pillar 3 supports legal and institutional reforms necessary to improve the resiliency and efficiency of the banking system in the medium to longer term.

70. **The program supported by the FSDPL series has been strengthened in response to worsening conditions in the financial.** In response to the deteriorating environment in the economy and financial sector, prior actions for FSDPL2 have been significantly strengthened. Pillar 1 has been strengthened to support the authorities in addressing key operational deficiencies in the DGF that became apparent as the number of bank failures increased. Pillar 2 has been strengthened to include the launch of an updated set of diagnostic studies to ensure that the banking system is adequately capitalized, while also supporting the authorities in implementing the

recapitalization and restructuring program for the top banks based on diagnostic studies that were conducted in mid-2014 as envisaged when the FSDPL series was prepared. Pillar 3 has been strengthened to increase the focus on decreasing the level of related-party lending in the system as it became apparent during the past year that the levels in the system were much higher than expected. These modifications, summarized in Table 6, do not affect the overall development objectives of the operation.

71. **The design of the programmatic series builds on the lessons from the 2008-09 financial crisis and long-standing policy dialogue with the 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 authorities should put in place a recapitalization program following diagnostic studies of the top banks, and take prompt action against those banks whose owners are unwilling or unable to provide the required capital. Finally, any use of state funds for recapitalizing private banks due to stability concerns should be subject to clear, transparent, and narrow bank eligibility and governance criteria. The program is underpinned by significant analytical work that has been conducted by the World Bank in recent years through a programmatic financial sector TA program, a FIRST grant focused on the DGF, and more recently a SIDA TF. The design of the prior actions and triggers is based on the findings of this TA program (Table 7).

72. **The FSDPL series is complemented by a comprehensive TA program that is underway.** Significant TA is being provided to the DGF and NBU. The TA for the DGF focuses on implementing the legal changes that are being supported by the FSDPL series. In particular, TA is being provided to strengthen the institutional and operational capacity to implement the revisions in the resolution framework as well as to implement the changes in the asset recovery framework. Support to the NBU is being provided to improve banking and NBFI supervision through changes in the organizational framework and enhancing the capacity of key areas (e.g., related-party lending and IT supervision). TA is also being provided to develop a legal framework for out-of-court restructuring of NPLs.

Table 6: Program Modifications

Initial DPL2 Triggers	DPL2 Prior Actions	Reasons for change
Pillar 1: Strengthening the operational, financial and regulatory capacity of the DGF for resolution of insolvent banks		
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.	**Prior Action 1**: The Borrower has strengthened the DGF's financial capacity for bank resolution by establishing a back-up funding provision to DGF from the Borrower. **Prior action 2:** The Borrower has enabled the DGF to increase the speed of reimbursing insured depositors. **Prior action 3:** The Borrower has increased the efficiency of the asset management function of the DGF.	Pillar 1 has been strengthened to support the authorities in addressing key operational deficiencies in the DGF that became apparent as the number of bank failures increased. Prior to the crisis, the DGF had limited experience in resolving banks. As the number of failed banks has increased, additional weaknesses in reimbursing insured depositors and asset recovery have become apparent. Thus in addition to Trigger 1 that focused on ensuring the financial capacity of the DGF, two prior actions have been added to Pillar 1 to support policy reforms needed to improve the operational capacity of the DGF.

Pillar 2: Improving the solvency of the banking system through implementation of bank recapitalization/ restructuring plans and timely enforcement action		
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.	**Prior Action 4:** The Borrower has (a) certified the recapitalization of 13 out of the 35 Largest Banks in the amounts indicated by the independent diagnostic studies and; certified (b) (i) that 5 out of the 35 largest banks were unable to be recapitalized in the amount indicated by independent diagnostic studies and (ii) that such identified banks were transferred to the DGF for resolution. **Prior Action 5:** NBU has initiated updated diagnostic studies for the 20 largest banks, based on acceptable terms of reference. **Prior Action 6**: The Borrower has established a legal mechanism for state participation in bank recapitalization.	Pillar 2 has been strengthened as the crisis in the banking sector has been deeper than expected during the preparation of the FSDPL series. Thus in addition to supporting the NBU in implementing a recapitalization and restructuring process following the independent diagnostic process in mid-2014 supported by FSDPL1, pillar 2 has been modified to support the launch of an update of these diagnostic studies that take into account the worsening economic condition, currency depreciation, and conflict in the eastern part of the country.
Pillar 3: Strengthening the legal and institutional framework to improve resiliency and efficiency of the banking system		
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.	**Prior Action 7:** The Borrower has strengthened requirements for identifying and reporting related-party lending and has increased the NBU's powers for identifying bank related parties. **Prior Action 8:** NBU has initiated a review of banks' related-party lending, based on acceptable terms of references. **Prior Action 9:** The Borrower has established a high-level Financial Stability Council. **Prior Action 10**: NBU has issued regulatory and supervisory requirements for Systemically-important Banks.	Pillar 3 has been strengthened to increase the focus on decreasing related-party lending in the system as it became apparent during the past year that the levels in the system were much higher than expected. In addition to updating the legal and regulatory framework for related-party lending, the pillar supports the launch of a diagnostic process to adequately assess and unwind over the limit exposures. Due to the depth of the crisis, two of the triggers (related to NPLs and the divestiture of state-owned banks) have been removed from the prior actions for FSDPL2 as the crisis has deepened. Regarding the trigger on NPLs, the authorities are developing a broader set of reforms to support the reduction in NPLs in the system that includes changes in the judicial system, tax policies, supervision policies, and the introduction of a voluntary out of court restructuring framework. The World Bank and IMF are supporting these policy discussions, which have required additional time due to the magnitude of the crisis and the breadth of reforms needed. Regarding the divestiture of state banks, the market conditions have not been appropriate to sell banks. The World Bank is continuing to provide TA to the authorities on developing a strategy for the state- owned banks that includes divesting from the banks that were recapitalized during the 2008-09 crisis and improving the governance and oversight of the large state-owned banks that are expected to be retained.

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

73. **Pillar 1 aims to 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 54 banks have been declared insolvent and transferred for resolution to the DGF during the period of January 2014 to end-July 2015. Given the stress caused by the currency depreciation, downturn in the economy and conflict in the east, there are risks that a number of additional banks could be transferred to the DGF for resolution in the coming months.

74. **FSDPL1 strengthened key elements of the financial and operational capacity of the DGF.** The first operation supported the introduction of a backup funding mechanism for the DGF, put in place new resolution tools to handle the large number of bank insolvencies, increased the staffing of the DGF, and improved coordination between the NBU and the DGF. The policy changes supported by FSDPL1 have been critical in allowing the DGF to successfully manage the dramatic increase in its workload over the past few months.

75. **FSDPL2 focuses on ensuring that the DGF continues to have the financial resources needed to meet its depositors' obligations and further enhance its operational capacity.** The financial resources needed by the DGF in 2015 have been substantial to date, and likely to increase. FSDPL2 supports budgetary and policy changes needed to provide a larger amount of backup funding required due to the large number of bank failures. FSDPL2 has also supported the further strengthening of the operational capacity of the DGF, with a particular focus on recovering bad assets in failed banks and improving the efficiency of insured depositor payouts.

76. **Results:** Prior actions 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: (i) that all insured depositors are reimbursed for banks that are declared insolvent in 2014 and 2015; and (ii) the number of bank resolution plans implemented by the DGF.

Prior Action 1: The Borrower has strengthened the DGF's financial capacity for bank resolution by establishing a back-up funding provision to DGF from the Borrower, through enactment of Law of Ukraine #80-VIII "On the State Budget of Ukraine of Year 2015" dated December 28, 2014, (Official Gazette "Golos Ukrainy" #254 published on December 31, 2014); and adoption of the Cabinet of Ministers Resolution #156 "On provisioning the loan to the Individual Deposit Guarantee Fund" dated April 4, 2015.

77. **The DGF needs increased backup funding from the government to meet its legally mandated obligations.** Although premiums paid by banks are usually the source of funding for deposit insurance schemes, this source of income is no longer sufficient to handle the large volume of bank failures. This is usually the case during a financial crisis and backup funding is normally required to ensure depositor confidence and overall financial stability. To provide this back-up funding, FSDPL2 supported modifications to the 2015 state budget law to provide for the increased resources. A resolution by the Cabinet of Ministers was also issued to put in place the specific

mechanism that allowed the government to meet the increased financing needs of the DGF through the issuance of government bonds to the DGF, which were subsequently monetized at the NBU and on the secondary market in order to reimburse insured depositors.

Prior Action 2: The Borrower has enabled the DGF to increase the speed of meeting its obligations to insured depositors, through enactment of Law of Ukraine #629-VIII "On Amendments to Some Legislative Acts of Ukraine in Respect of the Improvement of the Individual Deposit Guarantee System and the Resolution of Insolvent Banks" dated July 16, 2015 (Official Gazette "Golos Ukrainy" #146 published on August 11, 2015).

78. **The increased workload at the DGF has revealed weaknesses in the current legal and institutional framework that need to be addressed to ensure that it has the operational capacity to deal with those banks that have been passed to the DGF for resolution, and any other banks that might fail in the near future.** FSDPL2 supported changes in the DGF law to increase the speed of reimbursing insured depositors. Prior to the current crisis, the DGF had only resolved two small banks, and had limited experience in ensuring that insured depositors were reimbursed in a timely manner. During recent months, as the workload of the DGF increased, DGF's capacity to reimburse insured depositors in a timely and efficient manner emerged as a critical challenge in maintaining financial stability. Barriers to speedy insured depositor reimbursement included a lengthy decision making process for determining the least cost resolution, limited information from the NBU on problem banks, and extended timeframes in the DGF law for reimbursing insured depositors. FSDPL2 supported changes to the legal framework that, amongst other things, allow for the prequalification of bidders to speed up the resolution decision making process, increase information sharing on problem banks from the NBU to the DGF, and decrease the legally mandated timeframe for reimbursing insured depositors.

Prior Action 3: The Borrower has increased the efficiency of the asset management function of the DGF through: (a) enactment of Law of Ukraine #629-VIII "On Amendments to Some Legislative Acts of Ukraine in Respect of the Improvement of the Individual Deposit Guarantee System and the Resolution of Insolvent Banks" dated July 16, 2015 (Official Gazette "Golos Ukrainy" #146 published on August 11, 2015); and (b) adoption by the DGF Executive Board of Decisions #145/15, dated June 30, 2015, #196/15, dated August 17, 2015, and #198/15, dated August 18, 2015.

79. **The DGF is currently facing challenges recovering assets from banks that are being liquidated.** The DGF is responsible for recovering assets from banks that are being liquidated. Almost all of the banks that have been resolved by the DGF have been insured depositor payouts with the DGF then responsible for liquidating all of the assets. [20] This will require that the DGF recover on both good and problematic assets on behalf of the creditors of the failed bank. Prior to the crisis, DGF had established policies and procedures for asset liquidation and management that were satisfactory for a very small number of failures. FSDPL2 supported changes to the DGF law to increase the efficiency of the asset liquidation process, and to maximize the likelihood of recovery. Changes introduced include the ability of the DGF to sell and manage assets on a consolidated basis from the numerous failed banks, improve the efficiency of asset sales and auctions, enhance management and financial controls, and increase transparency and oversight of

[20] Only seven banks avoided liquidation with direct payouts: three Purchase and Assumption transactions, two bridge banks, and two full bank sales.

the asset recovery process. It is important to note that recoveries on the assets that are being liquidated by the DGF after satisfying creditors' claims will provide cash that will be used by DGF to repay the government for its financing of payouts; therefore improvements in the recoveries will reduce future fiscal costs associated with the government's funding of the DGF.

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

80. **This pillar aims to improve the solvency of the Ukrainian banking system.** FSDPL1 launched a time-bound recapitalization process based on independent diagnostic studies for the top 35 banks. FSDPL2 supported the development and implementation of credible recapitalization and restructuring programs for banks that were found to be undercapitalized, and resolution of the banks whose owners were unwilling or unable to provide the required capital. Considering the worsening conditions in Ukraine, a revised diagnostic process is being launched with the support of FSDPL2. FSDPL2 also supported legal changes to define the mechanism for dealing with systemic banks, including the potential use of state support for recapitalization.

81. **Results:** Prior actions under this pillar aim to ensure that the banking sector is adequately capitalized and resilient to further shocks. Results indicators for FSDPL2 focus on implementation of the required recapitalization following the results of the updated diagnostic studies for the top 20 banks, and achieving the required CAR for these banks following the diagnostic studies.

Prior Action 4: The Borrower has (a) certified the recapitalization of 13 out of the 35 Largest banks in the amounts indicated by the independent diagnostic studies and; certified (b) (i) that 5 out of the 35 largest banks were unable to be recapitalized in the amount indicated by independent diagnostic studies and (ii) that such identified banks were transferred to the DGF for resolution, all through adoption of NBU Decision #429 dated July 3, 2015, "On Progress of Implementing Activities on Capitalization Based on the Results of the Diagnostic Studies".

82. **FSDPL1 supported the launch of independent diagnostic studies for the top 35 banks.** Based on the results of these diagnostics and the capitalization needs identified, FSDPL2 supported the development and implementation of a recapitalization and restructuring process for banks identified as being undercapitalized. Out of the 35 banks that were included in the diagnostic process, 18 were found to be undercapitalized. 5 of the 18 undercapitalized banks were unable to implement recapitalization and restructuring plans in the amount needed, and were resolved by the DGF. The remaining 13 banks have implemented the plans in a satisfactory manner, with 12 of them having generated the full amount of capital required and one having brought in the majority of capital and set to raise the remaining amount by extending a subordinated loan in a manner that is final and irrevocable.[21]

Prior Action 5: NBU has initiated updated diagnostic studies for the 20 largest banks, based on acceptable terms of reference, through issuance of NBU Board Decision #260, dated April 15, 2015, "On Implementation of the Diagnostic Studies of Banks".

[21] To ensure the credibility of the recapitalization process, the bank' shareholders have blocked bank funds of UAH2.5 billion that will be immediately converted to subordinated debt by September 30 in case the envisaged extension of a subordinated loan that matures on this date does not materialize or if the extended loan does not meet the criteria for being counted as bank capital. This commitment of shareholders is final and irrevocable.

83. **The NBU is updating the diagnostic studies, as the situation in the banking sector has deteriorated.** FSDPL2 supported the launch of an updated set of diagnostic studies for the top 20 banks that take into account the worsening economic conditions, depreciation of the local currency, and the additional losses associated with the conflict in the east. Based on the results of these studies, undercapitalized banks (CAR < 10 percent) will be required to present credible recapitalization plans to complete the recapitalization by end-2018. If a bank is unable to present a credible plan or implement the plan in an acceptable manner, it will be transferred to the DGF for resolution (except in those few cases where the state could recapitalize the bank for stability purposes based on the legal changes introduced as part of Prior Action 6).

Prior Action 6: The Borrower has established a legal mechanism for state participation in bank recapitalization, through enactment of Law of Ukraine #78-VIII, "On Measures to Promote the Capitalization and Restructuring of Banks", dated December 28, 2014 (Official Gazette "Golos Ukrainy" #252-1 published on December 30, 2014) and Law of Ukraine #629-VIII "On Amendments to Some Legislative Acts of Ukraine in Respect of the Improvement of the Individual Deposit Guarantee System and the Resolution of Insolvent Banks" dated July 16, 2015 (Official Gazette "Golos Ukrainy" #146 published on August 11, 2015).

84. **FSDPL2 supported a legal mechanism for state participation in recapitalizing a private bank in a small number of cases where a least-cost resolution could impact financial stability.** While agreement on the key principles of state participation in bank recapitalization were supported under FSDPL1, legal changes supported by FSDPL2 have created the legal mechanism for state recapitalization in a small number of cases where the resolution of a bank on a least-cost basis via the DGF could impact financial stability. The legal changes ensure that public funds are only injected after shareholders have been completely wiped out, liabilities to bank related-parties and non-deposit unsecured creditors are "bailed in". The legal mechanism strictly limits the use of state recapitalization for private banks, and provides clear oversight by the authorities in the decision making to minimize the potential for state recapitalization for private banks that do not pose stability risks.

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

85. **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 resumption of sustainable financial intermediation.** The impact of current economic and political shocks on the banking system has been exacerbated by long-standing structural vulnerabilities. While Pillars 1 and 2 support the urgent policy actions necessary to stabilize the banking sector, Pillar 3 supports the 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 include: (i) measures aimed at reducing the level of related-party lending; (ii) improved coordination mechanisms among financial safety net players; and (iii) enhanced regulatory and supervisory requirements for domestic systemically important banks.

86. **Results**: The prior actions supported under this pillar are expected to lead to improved resiliency and efficiency of the banking system. Specific results will pertain to: (i) adoption of related-party lending unwinding plans for those banks whose related-party lending is in excess of

the norms established by the NBU (or resolution of those banks that cannot agree on plans); and (ii) reduction in the number of banks operating in Ukraine.

Prior Action 7: The Borrower has strengthened requirements for identifying and reporting related-party lending and has increased the NBU's powers for identifying bank related parties, through (a) enactment of Law of Ukraine #218-VIII, "On Amendments to the Legislative Acts on the Liabilities Associated with the Related Parties of Banks" dated March 2, 2015, (Official Gazette "Golos Ukrainy" #42 published on March 7, 2015); (b) adoption by NBU of NBU Regulation #312, dated May 12, 2015, "On Amendments to the Instruction on Regulation of Banks' Operations in Ukraine", (c) adoption by NBU of NBU Regulation #315, dated May 12, 2015, "On Approval of the Definition of Bank-related parties"; (d) adoption by NBU of NBU Regulation #328, dated May 21, 2015, "On Procedures for Reporting Bank Ownership Structure"; and (e) adoption by NBU of NBU Regulation #357, dated June 4, 2015, "On Amendments to the Regulation on Bank Licensing".

87. **One of the major weaknesses in the banking sector is the high level of related-party lending.** FSDPL2 supported legislative changes aimed at strengthening supervision of transactions with related parties, improving reporting requirements for transactions with such parties, enhancing disclosure requirements of bank owners, and increasing responsibility of related parties if their wrongful actions or failure to act caused damage to bank creditors. To better identify and enforce transactions with bank-related parties, new presumption powers have been given to the NBU. In the new framework, the NBU can identify and declare a party as related based on objective criteria. If the bank cannot justify to the NBU within 15 days that its presumption is incorrect, the party will be declared as related. In addition, the reporting framework of bank related parties has been improved and definition of bank ownership has been widened to cover all key shareholders. The responsibility of related parties has also been increased substantially. Bank-related parties are now subject to an increased civil and administrative penalty for the breach of laws and regulations and risky operations that pose a threat to the interests of depositors or other creditors of the bank. They will also be subject to criminal penalty for causing a bank insolvency, and will be held liable with all their personal property for the damages incurred by bank creditors if they are found to have caused a bank insolvency based on unlawful actions.

Prior Action 8: NBU has initiated a review of banks' related-party lending, based on acceptable terms of references, through adoption of NBU Board Decision #314, dated May 12, 2015, "On measures aimed at bringing banks' asset operations with related parties in compliance with the regulatory requirements".

88. **The NBU will use the revised legal framework for related-party lending supported by prior action 7 to identify and decrease the level of related-party lending in the system.** The NBU will utilize the new legal framework to conduct a diagnostic of the related-party lending in the top 10 private banks. Independent accounting firms will review these reports to make a determination of the level of related-party lending. After this review, banks with levels of related-party lending exceeding the regulatory norms will be required to present unwinding plans and an NBU committee (with the World Bank and IMF as observers) will make a recommendation on whether or not to approve related-party exposure unwinding plans. Banks with related-party lending exceeding the regulatory norms whose plans are not approved will be resolved. Banks that have plans approved will be required to meet agreed upon milestones and two breaches during the implementation of the unwinding plans will lead to the bank being closed and resolved. Although

the initial focus of the related-party lending diagnostic review is on the top 10 banks, a similar process will be conducted on the next 10 largest banks in the near future, and eventually for all the banks operating in Ukraine.

Prior Action 9: The Borrower has established a high-level Financial Stability Council, through enactment of Presidential Decree #170/2015, dated March 24, 2015 "On Financial Stability Council".

89. **This prior action supported 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 during normal and crisis times is critical for maintaining financial stability. To improve this coordination, FSDPL2 supported 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 potential risks to the country's financial stability, and possible remedial actions required if the risks materialize.

Prior Action 10: NBU has issued regulatory and supervisory requirements for Systemically-important banks, through adoption of NBU Regulation #312, dated May 12, 2015, "On Amendments to the Instruction on Regulation of Banks' Operations in Ukraine".

90. **An enhanced supervisory framework for domestically important systemic banks is being established with the support of FSDPL2.** Considering the challenges that large systemic banks have posed in the 2008-09 and current crisis, the authorities have prioritized putting in place enhanced supervisory and regulatory requirements for systemic banks. In line with enhanced risk monitoring and supervision, new Basel 3 requirements on capital buffers for systemic banks have been introduced. To further strengthen the resilience of systemic banks and increase the preparedness for dealing with potential crisis situations in a timely and orderly manner, the NBU is now mandating that systemic banks periodically prepare and submit recovery plans to the NBU. These measures will help to ensure that the banking system is more resilient in case a large bank operating in Ukraine faces challenges going forward.

Table 7: FSDPL2 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 the DGF's financial capacity for bank resolution by establishing a back-up funding provision to DGF from the Borrower. **Prior Action 2**: The Borrower has enabled the DGF to increase the speed of reimbursing insured depositors. **Prior Action 3:** The Borrower has increased the efficiency of the asset management function of the DGF	The World Bank has had a multi-year engagement with the DGF prior to the current crisis that was funded by two FIRST grants and through a Financial Sector Monitoring TA. This work supported the authorities in quickly identifying the critical policy reforms needed at the onset of the crisis. Since the crisis began, complementary TA has been provided to the DGF through the ongoing FIRST grant and Financial Sector Monitoring TA, as well as a SIDA TF that became effective in December, 2014. The reforms that are being supported in the DGF aim to eventually align the DGF with the EC Directives on Deposit Insurance.

Pillar 2: Improving the solvency of banking system through implementation of bank recapitalization/ restructuring plans and timely enforcement action	
Prior Action 4: The Borrower has (a) certified the recapitalization of 13 out of the 35 Largest Banks in the amounts indicated by the independent diagnostic studies and; certified (b) (i) that 5 out of the 35 largest banks were unable to be recapitalized in the amount indicated by independent diagnostic studies and (ii) that such identified banks were transferred to the DGF for resolution. **Prior Action 5:** NBU has initiated updated diagnostic studies for the 20 largest banks, based on acceptable terms of reference. **Prior Action 6:** The Borrower has established a legal mechanism for state participation in bank recapitalization.	The World Bank had a multi-year engagement with the NBU prior to the crisis that was funded by a Financial Sector Monitoring TA. This work provided the foundation for the policy reforms supported by the FSDPL series even though much of the prior work had gained minimal traction. However, this engagement has helped to support the authorities in developing an effective crisis management program. Since the crisis began, the World Bank has been providing complementary TA to support the reforms in this pillar utilizing a SIDA TF and a Financial Sector Monitoring TA. The policy reforms supported by this pillar are based on international experience in crisis management. They also build on experience from the 2008-09 financial crisis in Ukraine, and the lessons learned from a financial sector DPL that was approved in 2009.
Pillar 3: Strengthening the legal and institutional framework to improve resiliency and efficiency of the banking system	
Prior Action 7: The Borrower has strengthened requirements for identifying and reporting related-party lending, and has increased the NBU's powers for identifying bank related parties. **Prior Action 8:** NBU has initiated a review of banks' related-party lending, based on acceptable terms of references. **Prior Action 9:** The Borrower has established a high-level Financial Stability Council. **Prior Action 10:** NBU has issued regulatory and supervisory requirements for Systemically-important Banks.	Prior to the crisis, a Financial Sector Monitoring TA was utilized to develop proposals on needed reforms in the banking sector in areas such as related-party lending, banking supervision, and reducing NPLs. Although this work did not gain much traction prior to the current crisis, it has been critical in being able to quickly support the new management of the NBU in rapidly identifying and implementing reforms in the financial sector. The World Bank TA to the support the development of the NBU has greatly increased in recent months, with support from the World Bank Vienna Center for Financial Sector Advisory Services, a SIDA TF, and a Financial Sector Monitoring TA. The policy reforms supported by this pillar aim to bring the supervisory and regulatory framework for the banking system in line with international standards.

4.3. LINK TO CPS AND OTHER BANK OPERATIONS

91. **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 multi-sector DPL series 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.

92. **The FSDPL series is the cornerstone of the World Bank Group's broader program to support Ukraine's financial sector development.** The program also includes a number of IBRD, IFC and MIGA products with specific financial intermediaries, and an extensive advisory services/ TA engagement by the World Bank Group.

4.4 CONSULTATIONS AND COLLABORATION WITH DEVELOPMENT PARTNERS

93. **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 addition, legislative changes adopted as part of the FSDPL series have been subject to extensive deliberation by members of Parliament, and with civil society.

94. **The World Bank has also collaborated with the IMF and other development partners in the course of preparing this operation.** The financial sector program supported by the FSDPL series is closely aligned to the financial sector policies supported by the IMF EFF. The World Bank and IMF teams have worked closely with the authorities to ensure consistency and the two programs complement each other. The World Bank is also collaborating with the United States Treasury and European Bank for Reconstruction and Development in supporting the DGF. Finally, the German Government is using the prior actions in Pillar 1 related to the DGF as part of its disbursement conditions for a EUR 200 million loan to Ukraine.

5. OTHER DESIGN AND APPRAISAL ISSUES

5.1 POVERTY AND SOCIAL IMPACT

95. **The crisis threatens to reverse some of the gains Ukraine made in earlier years in reducing poverty and boosting shared prosperity.** As a result of rapid growth, especially before the global economic crisis, the poverty rate declined from 23.2 percent in 2007 to 6.2 percent in 2013.[22] From 2008 to 2013, the average income of the bottom 40 percent grew 50 percent faster than that of the rest of the population (4.2 percent vs. 2.8 percent annually), reflecting higher wage increases (4.6 percent vs. 2.7 percent annually). However, real incomes, including those of the poor and of the bottom 40 percent, are under pressure as a result of the economic contraction, rising unemployment, pension and wage freezes, high inflation, and large increases in utility tariffs. Pension freezes affect women disproportionately, as 70 percent of single pensioners are women and their pensions are 30 percent lower on average than those of men (as a result of a 26 percent wage gap and a difference of 5 years in retirement age in favor of men). After years of robust growth, domestic consumption is estimated to have declined by 7.4 percent in 2014, and by 15.4 percent in the first quarter of 2015. Poverty is estimated to have increased to 11.4 percent in 2014, and is expected to rise again in 2015 to at least 20.6 percent[23] given the challenging economic outlook. If macroeconomic and fiscal challenges intensify, there are risks of an even bigger poverty increase. The eastern regions, which tended to be poorer even before the conflict, are the most affected with internally displaced people being particularly vulnerable to becoming poor. The UN estimates that 60 percent of those displaced are women.

96. **The policy reforms supported by the FSDPL series aims to minimize the impact of**

[22] World Bank staff calculations using the actual income distribution and poverty line of 2012 fixed in real terms. This avoids the problems of adopting official poverty lines in Ukraine that are not constant in terms of purchasing power.

[23] These estimates are based on a scenario of distributionally neutral contractions of 6.8 percent in 2014 and 12.0 percent in 2015. To the extent that the poor are more vulnerable to different shocks, poverty could be higher.

the crisis on households. Global experience has shown that financial crises tend to disproportionally impact the poor and the bottom 40 percent. The policy reforms supported by the FSDPL series aim to minimize the short-term impact of the banking crisis on the poor and bottom 40 percent. Pillar 1 focuses on strengthening the financial and operational capacity of the DGF and will ensure that almost all[24] of the poor and bottom 40 percent have their savings fully reimbursed in the case of a bank failure. In addition, smaller enterprises are often amongst the most vulnerable during a banking crisis, and the legal amendments supported by the FSDPL series have expanded the deposit insurance coverage to individual entrepreneurs.

97. **The policy reforms that aim to create a healthier and more viable banking system will help to increase access to finance, and lower costs by increasing efficiency of the system.** Even prior to the crisis, access to finance in Ukraine was relatively low. According to 2014 data from the Global Financial Inclusion Database by the World Bank, 53 percent of adults in Ukraine had any type of bank account (44 percent for the poorest 40 percent). In terms of making savings, the numbers are even lower, with only 8 percent of adults reporting to make any savings in the form of bank deposits during the recent year (3 percent for the poorest 40 percent).

98. **No actions requiring a gender angle were identified given the nature of the reforms and the FSDPL2 targets**. Nevertheless, the team will monitor all available sources of data to ensure that project impacts do not reinforce gender inequalities.

99. **Communities and individuals who believe that they are adversely affected by specific country policies supported as prior actions or tranche release conditions under a World Bank Development Policy Operation may submit complaints to the responsible country authorities, appropriate local/national grievance redress mechanisms, or the World Bank's Grievance Redress Service (GRS).** The GRS ensures that complaints received are promptly reviewed in order to address pertinent concerns. Affected communities and individuals may submit their complaint to the World Bank's independent Inspection Panel which determines whether harm occurred, or could occur, as a result of World Bank's non-compliance with its policies and procedures. Complaints may be submitted at any time after concerns have been brought directly to the World Bank's attention, and Bank Management has been given an opportunity to respond. For information on how to submit complaints to the World Bank's corporate GRS, please visit www.worldbank.org/grs. For information on how to submit complaints to the World Bank's Inspection Panel, please visit www.inspectionpanel.org.

5.2 ENVIRONMENTAL ASPECTS

100. **The proposed FSDPL2 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.

[24] The DGF insures deposits up to UAH 200,000 (or about US$9,000) and fully covers 98 percent of all household depositors in Ukraine.

5.3 PFM, DISBURSEMENT AND AUDITING ASPECTS

101. **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 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 SOEs; (v) flaws in public procurement that limited competitiveness; (vi) limited focus on systems performance by the internal audit function; and (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 Multi sector DPL series.

102. **Foreign Exchange.** In line with the recommendations of the IMF safeguards assessment[25] of the NBU, the NBU is taking the necessary measures to improve NBU governance and autonomy as well as NBU internal controls. The NBU has adopted legislative amendments to the NBU Law to address the governance and autonomy issues. This will include prompt re-establishment of an Audit Committee following constitution of a new Council of the NBU. With regards to internal controls, the NBU has established a permanent senior-level credit committee in June 2015 to oversee NBU's lending to financial institutions. Further, a new loan origination and management process is being developed and will be implemented by October 2015.

103. **The most recent audit opinion on the consolidated financial statements of the NBU for the financial year ended December 31, 2014 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 observed the impact of the continuing economic crisis and political turmoil in Ukraine and noted that their final resolution was unpredictable and may adversely affect the Ukrainian economy and the operations of the NBU and its subsidiaries.

104. **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 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

[25] The purpose of a safeguards assessment is to provide reasonable assurance to the IMF that a central bank's control, accounting, reporting and auditing systems are adequate to ensure the integrity of operations.

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.

5.4 MONITORING AND EVALUATION

105. **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 from the DGF, MoF and NBU data sources. Baseline and updated data will be provided by each of these institutions and tracked according to the list of quantitative results indicators included in the Policy and Results Matrix (Annex 1). Considering the nature of the operation, specific individual beneficiary tracking indicators are not included.

6. SUMMARY OF RISKS AND MITIGATION

106. **Overall risks to this operation are high.** The following main risks can be identified:

- **Political, governance and stakeholder risks.** Despite the Minsk II agreement, concluded on February 11, 2015, the security situation in eastern Ukraine remains fragile. Renewed escalation of violence and prolonged confrontation could undermine the authorities' ability to continue reforms, including those supported by the operation. Escalation and/or widening of regional tensions could have serious economic consequences given Ukraine's strong ties to the Russian economy in the past. Disruption in exports and/or gas supplies for a prolonged period are seriously affecting Ukraine's economic prospects in the short run and these risks cannot be mitigated by this operation. Moreover, while there is wide-spread public support for reforms, vested interests remain strong and continue to oppose certain reforms. These groups, in the presence of weak institutions, could undermine the reform program supported by the FSDPL series even if the authorities maintain their strong commitment to reforms. In addition, public support may weaken if social impacts of the banking reform measures become more severe. The design of the operation mitigates these political economy risks, at least partially. The program explicitly seeks to ensure a balanced burden-sharing of reforms, including ensuring that a large majority of household depositors are covered up to the insured limit of UAH 200,000 and ensuring that the first loss is borne by the owners of the banks. The programmatic design of the operation moderates risks of reversals. In addition, the World Bank worked with other partners and IFIs on designing and tracking the reform program and will remain engaged through policy dialogue, TA, and public advocacy for strong reforms. Moreover, the World Bank team consulted civil society organizations, which may help to keep pressure on the authorities to sustain reforms.

- **Macroeconomic risks.** The macroeconomic risks outlined in paragraph 37 could affect the implementation, impact and sustainability of the reforms supported by this series. If currency pressures reemerge this could trigger mutually reinforcing depreciation, capital flight and inflation, which could in turn aggravate the banking crisis and hamper efforts to restore external and fiscal sustainability. These risks are compounded by the fragile balance of payments situation and risks to external and fiscal financing. Failure to reach agreements with private creditors, consistent with the assumptions underlying the baseline macroeconomic framework, would exacerbate external liquidity constraints, especially in 2016-17, when official inflows are expected to subside. Efforts to restore sustainable public finances could prove to be more challenging than expected, especially in case of a deeper and/or protracted downturn. Finally, problems in the financial sector can create a vicious circle between initial macroeconomic shocks, balance sheet problems in banks, and instability and liquidity in financial markets. This could deepen the economic downturn and may impose a fiscal burden on the budget.
- **Risks related to sector strategies and policies, and technical design of the program.** The government's program to mitigate the impact of the financial crisis will extend well beyond the scope of the FSDPL series. Although the FSDPL series has supported initial measures to stabilize the sector, significant risks remain in the sector, as the downturn in the banking sector has become much worse than what was envisaged during preparation of the FSDPL series in mid-2014. This includes the potential that the updated diagnostic process for the top 20 banks reveals significant capital shortfalls and owners are unable or unwilling to provide the needed capital. In addition, given the number of foreign banks in the top 20 and the protracted downturn in Ukraine, there is a risk that one or many foreign banks are unwilling to support their subsidiaries. These risks are somewhat mitigated by the recently introduced legal framework for resolving systemically important banks that was supported by FSDPL2. In addition, fiscal resources to deal with possible new bank failures have been included in the baseline budget. These resources have been estimated based on existing reported information. In addition, the ongoing IMF's EFF and further World Bank TA will support the authorities' ongoing financial sector reform program.
- **Risks related to institutional capacity for implementation and sustainability.** The FSDPL series is focused on putting in place improved legal frameworks. Enacting good laws is an important and necessary first step, but consistent implementation is required for this to translate into effective change. Incomplete implementation either due to lack of resources, capacity constraints, resistance from special interest groups, or escalating violence could undermine the impact of the operation. While the program strengthens the NBU and DGF, and provides additional tools to deal with the current financial crisis and strengthen the financial sector in the medium term, the success of this program will depend on the continued institutional development of both institutions. Ongoing TA provided to support the strengthening the NBU and DGF by the Bank and other development partners partially mitigate these risks.
- **Fiduciary Risks.** The fiduciary assessment concludes that fiduciary risks for DPOs are substantial. This rating considers proposed prior actions, and also takes into account: (i) ongoing Public Financial Management (PFM) reform efforts currently

being supported by the Bank, including support for modernizing public procurement legislation; (ii) modernization of treasury operations; and (iii) strengthening the effectiveness of the Accounting Chamber and the Public Internal Financial Audit and Control function. It also considers the ongoing political and economic situation in Ukraine.

- **Social Risks:** The current banking crisis has widespread social costs and in particular for depositors (both household and corporate) that are losing money in the banks that have failed. This is partially mitigated by the fact that the operation aims to support the DGF in meeting its legally mandated responsibility to cover household depositors up to UAH 200,000 (which covers the large majority of households in full), and aims to ensure that the system is adequately capitalized to restore confidence in the sector.

Table 8: Systematic Operations Risk-rating Tool

Risk Category	**Rating (H,S,M,L*)**
Political and governance	H
Macroeconomic	H
Sector strategies and policies	H
Technical design of program	H
Institutional capacity for implementation and sustainability	H
Fiduciary	S
Environment and social	H
Stakeholders	H
Overall	**H**

Note: High (H), Substantial (S), Moderate (M), Low (L)

ANNEX 1: FSDPL POLICY AND RESULTS MATRIX

Prior Actions for FSDPL 1	Prior Actions for FSDPL 2	Results
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[26] 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.	**Prior Action 1:** The Borrower has strengthened the DGF's financial capacity for bank resolution by establishing a back-up funding provision to DGF from the Borrower, through enactment of Law of Ukraine #80-VIII "On the State Budget of Ukraine of Year 2015" dated December 28, 2014, (Official Gazette "Golos Ukrainy" #254 published on December 31, 2014); and adoption of the Cabinet of Ministers Resolution #156 dated April 4, 2015 "On provisioning the loan to the Individual Deposit Guarantee Fund". **Prior Action 2:** The Borrower has enabled the DGF to increase the speed of meeting its obligations to insured depositors, through enactment of Law of Ukraine #629-VIII "On Amendments to Some Legislative Acts of Ukraine in Respect of the Improvement of the Individual Deposit Guarantee System and the Resolution of Insolvent Banks" dated July 16, 2015 (Official Gazette "Golos Ukrainy" #146 published on August 11, 2015). **Prior Action 3**: The Borrower has increased the efficiency of the asset management function of the DGF through: (a) through enactment of Law of Ukraine #629-VIII "On Amendments to Some Legislative Acts of Ukraine in Respect of the Improvement of the Individual Deposit Guarantee System and the Resolution of Insolvent Banks" dated July 16, 2015 (Official Gazette "Golos Ukrainy" #146 published on August 11, 2015); and (b) adoption by the DGF Executive Board of Decisions #145/15, dated June 30, 2015, #196/15, dated August 17, 2015, and #198/15, dated August 18, 2015.	Depositors reimbursed in banks that were declared insolvent in 2014 and 2015 Baseline (2014): NA Target (2016): 100 percent Number of bank resolution plans adopted by DGF (cumulative) Baseline (2013): 2 Target (2016): 54

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.	**Prior Action 4:** The Borrower has (a) certified the recapitalization of 13 out of the 35 Largest Banks in the amounts indicated by the independent diagnostic studies and; certified (b) (i) that 5 out of the 35 largest banks were unable to be recapitalized in the amount indicated by independent diagnostic studies and (ii) that such identified banks were transferred to the DGF for resolution, all through adoption of NBU Decision #429 dated July 3, 2015, "On Progress of Implementing Activities on Capitalization Based on the Results of the Diagnostic Studies". **Prior Action 5:** NBU has initiated updated diagnostic studies for the 20 largest banks, based on acceptable terms of reference, through issuance of NBU Board Decision #260, dated April 15, 2015, "On Implementation of the Diagnostic Studies of Banks". **Prior Action 6:** The Borrower has established the legal mechanism for state participation in bank recapitalization, through enactment of Law of Ukraine #78-VIII, "On Measures to Promote the Capitalization and Restructuring of Banks", dated December 28, 2014 (Official Gazette "Golos Ukrainy" #252-1 published on December 30, 2014) and Law of Ukraine #629-VIII "On Amendments to Some Legislative Acts of Ukraine in Respect of the Improvement of the Individual Deposit Guarantee System and the Resolution of Insolvent Banks" dated July 16, 2015 (Official Gazette "Golos Ukrainy" #146 published on August 11, 2015).	Bank recapitalization plans approved by the NBU for the top 20 banks (or resolution of those that cannot be agreed to) based on revised diagnostic studies: Baseline (2014): NA Target (2016): 100 percent CAR for the top 20 banks that underwent the updated diagnostic process Baseline (2015): NA Target (2016): >5% CAR

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.	**Prior Action 7:** The Borrower has strengthened requirements for identifying and reporting related-party lending and has increased the NBU's powers for identifying bank related parties, through (a) enactment of Law of Ukraine #218-VIII, "On Amendments to the Legislative Acts on the Liabilities Associated with the Related Parties of Banks" dated March 2, 2015, (Official Gazette "Golos Ukrainy" #42 published on March 7, 2015); (b) adoption by NBU of NBU Regulation #312, dated May 12, 2015, "On Amendments to the Instruction on Regulation of Banks' Operations in Ukraine", (c) adoption by NBU of NBU Regulation #315, dated May 12, 2015, "On Approval of the Definition of "bank related parties"; (d) adoption by NBU of NBU Regulation #328, dated May 21, 2015, "On Procedures for Reporting the Bank Ownership Structure"; and (e) adoption by NBU of NBU Regulation #357, dated June 4, 2015, "On Amendments to the Regulation on Bank Licensing" . **Prior Action 8:** NBU has initiated a review of banks' related-party lending, based on acceptable terms of references, through adoption of NBU Board Decision #314, dated May 12, 2015, "On measures aimed at bringing banks' asset operations with related parties in compliance with the regulatory requirements". **Prior Action 9:** The Borrower has established a high-level Financial Stability Council, through enactment of Presidential Decree #170/2015, dated March 24, 2015, "On Financial Stability Council". **Prior Action 10:** NBU has issued regulatory and supervisory requirements for Systemically-important Banks, through adoption of NBU Regulation #312, dated May 12, 2015, "On Amendments to the Instruction on Regulation of Banks' Operations in Ukraine".	Consolidation of banking sector in Ukraine (number of banks) Baseline (2013): 181 banks Target (2016): 100 banks Agreement on related-party lending unwinding plans by the top 10 banks (or resolution of those banks that cannot agree on plans) Baseline (2014): NA Target (2016): 100 percent

ANNEX 2: LETTER OF DEVELOPMENT POLICY

14257/0/2-15 від 20.08.15

Лист Уряду України і Національного банку України стосовно політики розвитку у фінансовому секторі

Шановний пане Кім!

Уряд України і Національний банк висловлюють свою глибоку повагу Світовому банку та Вам особисто і мають честь повідомити Вам про нижченаведене.

Ми високо цінуємо Вашу підтримку реформ фінансового сектору в Україні та очікуємо, що наше партнерство в рамках нової Другої програмної позики на політику розвитку фінансового сектору (ППРФС-2) сприятиме стабілізації фінансового сектору в Україні та закладенню підвалин його реструктуризації.

Макроекономічна база

Незважаючи на надзвичайно складні умови, Уряд України продовжує вживати заходів для забезпечення макроекономічної стабільності, удосконалення управління та поліпшення ділового клімату.

Конфлікт на сході України завдав суттєвої шкоди національній економіці через потужний шок, якого зазнала промислова база разом з фінансовими і валютними ринками, а, отже, прискорилось і падіння валового внутрішнього продукту. Наведене ускладнило реалізацію наших зусиль з досягнення макроекономічної стабільності. Суттєва девальвація національної грошової одиниці призвела до збільшення дефіциту НАК "Нафтогаз України", навіть незважаючи на підвищення тарифів у 2014 році. Це мало своїм наслідком зростання консолідованого загального дефіциту Уряду та публічного боргу. Погіршення ситуації з рахунком капіталів у рамках платіжного балансу і потреба у погашенні заборгованості з платежів за природний газ спричинили суттєве скорочення валютних резервів. Початкові статистичні дані за 2015 рік засвідчують, що триває скорочення обсягів виробництва, торгівлі та будівництва через глибоке падіння економіки на сході держави.

Визнаючи складну ситуацію в економіці України, Уряд і Національний банк вживають узгоджених заходів для подолання економічної та фінансової кризи. Зокрема, ми звернулися із запитом до МВФ щодо заміни Програми "стенд-бай" на Програму розширеного фінансування (EFF) і 11 березня 2015 р. Рада директорів МВФ затвердила таку програму для України в обсязі 17,5 млрд. доларів США (900 відсотків квоти і 12,35 млрд. СПЗ) строком на чотири роки. Рада виконавчих директорів МВФ 31 липня 2015 р. завершила перший перегляд (EFF) і затвердила виділення

1 182,1 млн. СПЗ (близько 1,7 млрд. доларів США). У цілому Україна вже отримала від МВФ 4,72 млрд. СПЗ (близько 6,68 млрд. доларів США) для того, щоб закласти основу для економічних коригувань (гнучкий валютний курс, фіскальна консолідація та монетарне таргетування) та структурних реформ з метою поліпшення національної економіки та підвищення рівня життя населення.

Фінансовий сектор

Девальвація гривні, економічна криза, що триває, та конфлікт на сході держави спричинили суттєве напруження для банків, що працюють в Україні. Це призвело до відпливу коштів з банків, значної кількості випадків їх банкрутств, скорочення показників нормативу достатності капіталу у банківській системі, погіршення якості позик.

З кінця 2014 року і до кінця червня 2015 р. з банківської системи було забрано 29 відсотків вкладів фізичних осіб у гривні та 54 відсотки вкладів фізичних осіб у валюті. З огляду на це Національний банк поряд із традиційним механізмом підтримки ліквідності скористався спеціальними інструментами підтримки ліквідності банків, що допомогли зберегти достатню ліквідність у банківській системі.

Унаслідок складних економічних обставин у період з січня 2014 р. по липень 2015 р. 54 банки були передані до Фонду гарантування вкладів фізичних осіб (далі — Фонд) для виведення з ринку. На решту банків, що залишилися працювати в Україні, впливає суттєвий тиск, і норматив достатності капіталу банківської системи також скоротився — цей показник дорівнював 9 відсотків наприкінці червня 2015 року.

Також в останні місяці у банківській системі відбулося погіршення якості активів. Коефіцієнт "поганих" кредитів в останні місяці зріс з 18,9 відсотка у січні 2015 р. до 24,7 відсотка наприкінці березня.

Ми визнаємо наявність значного тиску на фінансовий сектор в Україні та зобов'язалися вжити належних заходів політики, щоб унеможливити виникнення фінансової кризи. Уряд і Національний банк вживають оперативних заходів, спрямованих на подолання кризи у короткостроковій перспективі та на забезпечення більшої стійкості та ефективності фінансового сектору в середньостроковій перспективі.

У зв'язку з цим ми цінуємо підтримку, яку отримуємо від Світового банку, МВФ і ЄБРР, а також від ряду двосторонніх донорів.

Порядок денний реформ

Уряд України і Національний банк продовжують комплексну програму антикризового управління у фінансовому секторі для унеможливлення широкомасштабної дестабілізації у фінансовому секторі і в економіці в цілому. Оскільки існує ймовірність того, що на сьогодні тиск на фінансовий сектор зберігатиметься протягом певного часу, ми вживаємо термінових заходів, щоб унеможливити додаткові банкрутства банків та забезпечити розв'язання будь-яких проблем з їх платоспроможністю в такий спосіб, щоб унеможливити виникнення фінансової кризи.

Фінансова криза, яка мала місце в 2008—2009 роках, виявила потребу у забезпеченні наявності у Фонді достатньої спроможності для роботи із збанкрутілими банками і відверненні можливої широкомасштабної дестабілізації фінансової системи через участь держави у капіталізації або в інший спосіб. З цією метою Уряд України визначив як пріоритет потребу у збільшенні фінансових та операційних ресурсів, наявних у Фонді, для забезпечення виведення з ринку збанкрутілих банків на основі методу найменших витрат та оперативного отримання вкладниками коштів з гарантованими сумами відшкодування відповідно до Закону України "Про систему гарантування вкладів фізичних осіб". Водночас ми визнаємо, що Національному банку необхідно мати всебічну і точну інформацію про фінансовий стан діючих банків для забезпечення капіталізації або реструктуризації банків, щодо яких буде виявлено недостатність капіталу. Крім цього, ми визнаємо необхідність оновлення бази нормативно-правового забезпечення та нагляду із приділенням особливої уваги рівню кредитування пов'язаних осіб.

У зв'язку з багаторічною історією ефективної співпраці із Світовим банком ми просимо Банк підтримати нашу політику розвитку у фінансовому секторі України.

Поступ у ППРФС-2

У рамках нашої програми з відновлення фінансової системи та унеможливлення широкомасштабної дестабілізації у фінансовому секторі і в економіці в цілому Уряд України активно вживає узгоджених із Світовим банком заходів для підготовки Другої програмної позики на політику розвитку фінансового сектору в таких ключових сферах:

зміцнення операційної, фінансової та регуляторної спроможності Фонду щодо врегулювання неплатоспроможних банків;

зміцнення рівня платоспроможності банківської системи шляхом виконання планів з капіталізації/реструктуризації банків і забезпечення своєчасного здійснення заходів впливу;

зміцнення правової та інституційної основи для підвищення стійкості та ефективності банківської системи.

Уряд України повністю виконав попередні заходи, узгоджені в рамках Другої програмної позики на політику розвитку фінансового сектору.

Операційна, фінансова та регуляторна спроможність Фонду була удосконалена шляхом здійснення заходів з надання Фонду додаткового фінансування, прискорення виплат вкладникам і підвищення ефективності управління активами.

Законом України "Про Державний бюджет України на 2015 рік" передбачено можливість надання Урядом України додаткового фінансування Фонду шляхом випуску облігацій внутрішньої державної позики в обмін на векселі Фонду на загальну суму 20 млрд. гривень в межах дефіциту та у разі необхідності поза його межами, з тим, щоб забезпечити виведення неплатоспроможних банків з ринку і здійснення виплат вкладникам необхідних відшкодувань. Такий механізм надання додаткового

фінансування уточнений у постанові Кабінету Міністрів України від 4 квітня 2015 р. № 156 "Про забезпечення надання кредиту Фонду гарантування вкладів фізичних осіб".

Закон України "Про внесення змін до деяких законодавчих актів України щодо вдосконалення системи гарантування вкладів фізичних осіб та виведення неплатоспроможних банків з ринку" запроваджує зміни до системи виведення банків для швидкої виплати відшкодування вкладникам. Зазначені зміни, серед іншого, дадуть змогу провести попередню кваліфікацію учасників торгів щодо переданих до Фонду неплатоспроможних банків, сприятимуть поліпшенню доступу до інформації з Національного банку для Фонду та зменшать законодавчо встановлені часові межі виплати відшкодування на користь вкладників.

Закон України "Про внесення змін до деяких законодавчих актів України щодо вдосконалення системи гарантування вкладів фізичних осіб та виведення неплатоспроможних банків з ринку" та рішення виконавчої дирекції Фонду від 30 червня 2015 р. № 145/15 запроваджують зміни, спрямовані на удосконалення функції Фонду із стягнення активів. Крім того, ці поправки надали Фонду право створити у своїй структурі "консолідований офіс з продажу активів неплатоспроможних банків".

Рівень платоспроможності банківської системи був зміцнений шляхом виконання планів з капіталізації / реструктуризації банків і забезпечення своєчасного здійснення заходів впливу.

За результатами незалежних діагностичних обстежень 35 найбільших банків Національний банк розглянув інформацію про виконання банками заходів з капіталізації після діагностичних обстежень та виявив, як були виконані вимоги щодо їх додаткової капіталізації. Це було затверджено постановою Правління Національного банку від 3 липня 2015 р. № 429 "Про стан виконання заходів щодо капіталізації за результатами діагностичного обстеження банків". Згідно з результатами діагностичних обстежень, 18 банків потребували додаткової капіталізації, 13 банків виконали взяті на себе зобов'язання, а 5 були виведені з ринку через Фонд.

Національний банк започаткував процес оновлення діагностичних обстежень щодо 20 найбільших банків шляхом ухвалення постанови Правління Національного банку від 15 квітня 2015 р. № 260 "Про здійснення діагностичного обстеження банків". Завдяки цьому будуть виявлені нестачі капіталу внаслідок девальвації обмінного курсу та конфлікту на сході України.

Закони України "Про заходи, спрямовані на сприяння капіталізації та реструктуризації банків" та "Про внесення змін до деяких законодавчих актів України щодо вдосконалення системи гарантування вкладів фізичних осіб та виведення неплатоспроможних банків з ринку" запровадили чіткі процедури та критерії виведення з ринку системно важливих банків.

Правова та інституційна основа для підвищення стійкості та ефективності банківської системи була зміцнена.

Закон України "Про внесення змін до деяких законодавчих актів України щодо відповідальності пов'язаних із банком осіб", постанови

Правління Національного банку від 12 травня 2015 р. № 312 "Про затвердження змін до Інструкції про порядок регулювання діяльності банків в Україні", від 12 травня 2015 р. № 315 "Про затвердження Положення про визначення пов'язаних із банком осіб", від 21 травня 2015 р. № 328 "Про затвердження Положення про порядок подання відомостей про структуру власності банку" та від 4 червня 2015 р. № 357 "Про затвердження Змін до Положення про порядок реєстрації та ліцензування банків, відкриття відокремлених підрозділів" посилюють основи здійснення нагляду за кредитуванням пов'язаних осіб у банківській системі. Такі зміни дають Національному банку повноваження бачити наявність економічних (пов'язаних) відносин між банками та позичальниками на основі об'єктивних критеріїв, підвищують вимоги до звітності та збільшують відповідальність пов'язаних осіб за порушення законів і нормативно-правових актів.

Постанова Правління Національного банку від 12 травня 2015 р. № 314 "Про заходи щодо приведення банками обсягів активних операцій з пов'язаними особами у відповідність до нормативних вимог" започаткувала проведення огляду щодо кредитування пов'язаних осіб у банківській системі. До кінця вересня 2015 р. Національний банк за технічної допомоги з боку міжнародних аудиторських компаній та відповідно до технічного завдання, погодженого із Світовим банком, завершить огляд звітів про ризики кредитування пов'язаних осіб у 10 найбільших банках. Згідно з аналогічною процедурою, Національний банк завершить проведення огляду щодо наступних 10 найбільших банків до кінця грудня 2015 р., а щодо решти банків — до кінця квітня 2016 року. За результатами таких оглядів банки подадуть до Національного банку плани дій з усунення кредитування пов'язаних осіб, що перевищує встановлену норму.

Указом Президента України від 24 березня 2015 р. № 170 "Про Раду з фінансової стабільності" створено Раду з фінансової стабільності, до складу якої увійшли представники Міністерства фінансів, Національного банку, Фонду, Національної комісії з цінних паперів та фондового ринку та Національної комісії, що здійснює державне регулювання у сфері ринків фінансових послуг. Рада з фінансової стабільності буде на постійній основі проводити засідання для обміну інформацією, обговорення ризиків та загроз фінансовій стабільності та узгодження можливих заходів.

Постановою правління Національного банку від 12 травня 2015 р. № 312 "Про затвердження змін до Інструкції про порядок регулювання діяльності банків в Україні" внесено зміни до системи нагляду та регулювання щодо системно важливих банків з урахуванням їх загальної важливості для фінансової стабільності в державі. Це, серед іншого, передбачає вимогу, згідно з якою системно важливі банки повинні готувати і подавати плани відновлення.

Наступні кроки з проведення реформ у фінансовому секторі

Користуючись нагодою, поновлюємо запевнення у тому, що Українська влада, як і раніше, прихильна до виконання програми реформ, підтриманих Першою та Другою програмними позиками на політику розвитку фінансового сектору. Відповідно до рішення Кабінету Міністрів України відповідальним за виконання Другої програмної позики на політику

розвитку фінансового сектору є Міністерство фінансів. Уряд України і Національний банк будуть продовжувати виконувати комплексну програму фінансового сектору, яка спрямована на відновлення фінансової системи і мінімізацію широкомасштабної дестабілізації у фінансовому секторі і в економіці в цілому.

Проводячи реформи, що підтримуються ППРФС-1 і ППРФС-2, ми будемо продовжувати зміцнювати фінансову та операційну спроможність Фонду. Зазначене включає в себе продовження забезпечення того, що Фонд має доступ до належного обсягу додаткових коштів. Ми також проведемо зміни, необхідні для прискорення виплати відшкодування та повернення активів відповідно до правових та інших змін, що підтримуються ППРФС-1 і ППРФС-2.

Ми будемо продовжувати забезпечувати платоспроможність банківської системи, використовуючи переглянуті діагностичні обстеження, підтримані ППРФС-2 для 20 найбільших банків. За результатами обстеження ми започаткуємо програми капіталізації банків, визнаних такими, що мають недостатній капітал. Ми також гарантуємо, що всі банки, за винятком системно важливих, будуть виводитися з ринку на основі методу найменших витрат. Будь-які рішення щодо системно важливих банків будуть ухвалюватися у прозорий спосіб з метою зниження загрози для фінансової стабільності та у рамках чинного правового поля за підтримки ППРФС-2.

Використовуючи реформи законодавчої та нормативно-правової бази, що підтримуються ППРФС-1 і ППРФС-2, ми будемо продовжувати зміцнювати правові та інституційні основи банківської системи для підвищення її стійкості та ефективності. Зокрема, після започаткування діагностичних обстежень щодо кредитування пов'язаних осіб в банківському секторі, що підтримується ППРФС-2, ми матимемо на меті завершення таких обстежень та запровадження планів з усунення кредитування пов'язаних осіб для тих банків, у яких було виявлено перевищення межі кредитування пов'язаних осіб.

З огляду на викладене Уряд України просить Світовий банк підтримати реформи стосовно Другої програмної позики на політику розвитку фінансового сектору у розмірі 500 млн. доларів США для сприяння стабілізації банківського сектору та закладення основи реструктуризації фінансового сектору.

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

Голова Національного банку України — **Валерія ГОНТАРЕВА**

Unofficial Translation

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

Dear Mr. Kim,

The Government of Ukraine and the National Bank of Ukraine express their profound respect to the World Bank and to you personally and have an honor to inform you as follows.

We highly appreciate your support to financial sector reforms in Ukraine and expect that our partnership within the scope of the new Second Programmatic Financial Sector Development Policy Loan (FSDPL2) to contribute to stabilizing the financial sector in Ukraine and laying the groundwork for restructuring.

Macroeconomic Framework

Despite an exceptionally tough environment, the Government of Ukraine continues to undertake measures to ensure macroeconomic stability, enhance governance and improve the business climate.

The conflict in eastern Ukraine caused significant damage to national economy through a large shock to the industrial base and to the financial and foreign exchange markets, thus accelerating the decline in gross domestic product. This complicated our efforts to achieve macroeconomic stability. A significant devaluation of the national currency caused increase in the deficit of Naftogaz Ukrainy even with increase in tariffs in 2014, which resulted in the growth of consolidated general government deficit and public debt. The deterioration of the capital account of the balance of payments and the need to cover the natural gas payment arrears led to a significant reduction in foreign exchange reserves. Initial statistical data for 2015 show continuing decline in production, trade and construction sectors, stemming from deep declines of the economy in the east.

Acknowledging the challenging economic situation in Ukraine, the Government and National Bank are taking concerted action to deal with the economic and financial crisis. In particular, we requested the IMF to replace its Stand-By Program with an Extended Fund Facility (EFF) and on March 11, 2015 the IMF Board approved a program for Ukraine in the amount of USD 17.5 billion (900 percent of quota and SDR 12.35 billion) for four years. On July 31, the Executive Board of the IMF completed the first review of the EFF and approved the disbursement of SDR 1,182.1 million (about US$1.7 billion). In total Ukraine already received from IMF SDR 4.72 billion (about US$6.68 billion) to underpin macroeconomic adjustment (a flexible exchange rate, fiscal consolidation and monetary tightening) and structural reforms to improve national economy and to increase leaving standards.

Financial Sector

The devaluation of the hryvnia, ongoing economic crisis, and conflict in eastern Ukraine has put a significant strain on the banks operating in Ukraine. It has led to an outflow of funds from banks, a significant number of bank failures, a decline in the capital adequacy ratio of the banking system, a deterioration of loan quality.

Since the end of 2014 to end June 2015, 29 percent of UAH household deposits and 54 percent of FX household deposits have been withdrawn from the banking system. With this in mind, the National Bank of Ukraine, in additional to traditional mechanisms to support liquidity, introduced special tools for supporting the liquidity of banks, which helped keep sufficient liquidity in the banking system.

As a result of the difficult conditions in the economy, 54 banks have been transferred to the Deposit Guarantee Fund (hereafter the Fund) for resolution during the period from January 2014 to July 2015. There has been significant pressure on the remaining banks operating in Ukraine, and the capital adequacy ratio for the banking system has also declined, and stood at 9 percent at end-June, 2015.

The quality of assets in the banking system has also deteriorated in recent months. The NPL ratio has increased in recent months, from 18.9 percent in January 2015 to 24.7 percent at the end of March.

We recognize the existence of significant pressures on the financial sector in Ukraine and are committed to taking appropriate policy measures to minimize the chances that these pressures will lead to a financial crisis. The Government of Ukraine and the National Bank of Ukraine are taking prompt measures aimed to overcome the crisis in the short term and to provide stability and efficiency in the financial sector in the medium term

In this regard, we appreciate the support we are receiving form the World Bank, IMF and EBRD, as well as from a number of bilateral donors.

Reform Agenda

The Government of Ukraine and the National Bank are continuing a comprehensive financial sector crisis management program to minimize the potential for a wide scale disruption in the financial sector and the overall economy. Since there is a possibility that the current pressure on the financial sector will remain for a certain period time, we are taking immediate action to minimize the possibility of additional bank failures and ensuring that any solvency problems are resolved in a way that minimizes the possibility of financial crisis.

The financial crisis that occurred in 2008-09 demonstrated the need to ensure that the Deposit Guarantee Fund has the adequate capacity to deal with failing banks, and that state participation via recapitalization or other methods should prevent the potential significant disruption of 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. In addition, we recognize the need to upgrade our regulatory

and supervisory framework, with a particular focus on decreasing the level of related-party lending.

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

Progress in FSDPL -2

As part of the our program to rehabilitate the financial system and minimize the potential for a wide scale disruption in the financial sector and the overall economy, the Government of Ukraine is taking measures agreed with the World Bank to prepare the "Second Programmatic Financial Sector Development Policy Loan" in the following key areas:

- Strengthening the operational, financial and regulatory capacity of the Deposit Guarantee Fund for the resolution of insolvent banks;
- Improving the solvency of the banking system through implementation of recapitalization/restructuring plans and timely enforcement measures;
- Strengthening the legal and institutional framework to improve the resiliency and efficiency of the banking system.

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

The operational, financial and regulatory capacity of the Deposit Guarantee Fund has been improved by implementing measures to provide back-up funding for the DGF, improving the speed of depositor payouts and increasing the efficiency of asset management.

The Law of Ukraine "On the State Budget of Ukraine of Year 2015" envisages the possibility of back-up funding of the Deposit Guarantee Fund (DGF) by the Government of Ukraine by issuing internal state bonds in exchange for DGF's promissory notes totaling 20 billion UAH within the deficit limits and, if needed, beyond the deficit limits, in order to ensure resolution of insolvent banks and necessary to payout depositors. Cabinet of Ministers Resolution #156"On provision the loan to the Individual Deposit Guarantee Fund" dated April 4, 2015 further clarified this back-up funding mechanism.

The Law of Ukraine "On Amendments to Some Legislative Acts of Ukraine in Respect of the Improvement of the Individual Deposit Guarantee System and the Resolution of Insolvent Banks puts in place changes to the resolution framework to increase the speed of reimbursing depositors. This includes changes allow for the prequalification of bidders for insolvent banks transferred to the DGF, improving the access of information from the NBU to the DGF, and decreasing the legally mandated timeframe for reimbursing depositors.

The Law of Ukraine "On Amendments to Some Legislative Acts of Ukraine in Respect of the Improvement of the Individual Deposit Guarantee System and the Resolution of Insolvent Banks" and DGF Executive Board of the Decision #145/15 puts in place changes to improve the asset recovery function of the DGF. These include the ability to structure a "consolidated office on the sale of assets of insolvent banks"

The solvency of the banking system has been improved through implementation of recapitalization/restructuring plans and timely enforcement measures.

Following the independent diagnostic assessments for the 35 largest banks, the National Bank of Ukraine considered information on banks' implementation of capitalization measures following the diagnostic study and acknowledged that their requirements for additional capitalization have been met, which was approved by NBU Board Resolution No.429 of 03 July 2015. According to the results of the diagnostic studies, 18 banks needed additional capitalization. 13 banks fulfilled the obligations undertaken, while 5 were resolved via the DGF.

The NBU has launched the process for updating the diagnostic studies for the 20 Largest Banks through issuing NBU Board Decision #260, dated April 15, 2015. This will identify capital shortfalls stemming from the exchange rate depreciation and conflict in eastern Ukraine.

The Law of Ukraine "On Measures to Promote the Capitalization and Restructuring of Banks" and Law of Ukraine "On Amendment to Some Legislative Acts of Ukraine in Respect of the Improvement of the Individual Deposit Guarantee System and the Resolution of Insolvent Banks" have established clear procedures and criteria for the resolution of systemically important banks.

The legal and institutional framework for the banking system has been improved to improve its resiliency and efficiency

The Law of Ukraine "On Amendments to the Legislation on the Liabilities Associated with the Related Party Lending", NBU Regulations #312, dated May 12, 2015 "On Amendments to the Instruction on Regulation of Banks' Operations in Ukraine", #315, dated May 12, 2015 "On Approval of the Definition of "bank related persons", №328, dated May 21, 2015 "On Procedures for Reporting the Bank Ownership Structure", and #357, dated June 4, 2015 "On Amendments to the Regulation on Bank Licensing" strengthens the framework for supervising related party lending in the banking system. The changes give the NBU the powers to observe the existence of an economic (related) relationship between banks and borrowers based on objective criteria; increase the reporting requirements; and increased the responsibility of related parties for breaches of laws and regulations.

NBU Board Decision #314 dated May 12, 2015 has launched a review of related party lending in the banking system. By end-September, 2015, the NBU, with technical support from international accounting firms and on the basis of terms of reference agreed with the World Bank, will complete a review of related party lending exposure reports from the top 10 banks. Following the same procedures, the NBU will complete reviews of the next 10 largest banks by end-December, 2015 and reviews of all other banks by end-April 2016. Subsequent to these reviews, the banks will submit to the NBU an action plan to unwind above-limit related party exposures.

Presidential Decree #170/2015 "On Financial Stability Council" dated March 24, 2015 has established a Financial Stability Council, whose members are representatives of the Ministry of Finance of Ukraine, National Bank of Ukraine, DGF, National Commission for Securities and Stock Market, and National Commission for State Regulation of Financial Services Markets. The Financial Stability Council will meet on a regular basis in order to exchange information and discuss threats and risks to financial stability and agree on potential preventive actions.

NBU Regulation #312, dated May 12, 2015 "On Amendments to the Instruction on Regulation of Banks' Operations in Ukraine" has altered the supervisory and regulatory framework for systemically important banks considering their overall importance to financial stability in the country. This includes the requirement for systemically important banks to prepare and submit recovery plans.

Next Steps in Implementation of the Financial Sector Reforms

We avail of this opportunity to renew assurances that we remain committed to the implementation of the reform program supported by the First and Second Programmatic Financial Sector Development Policy Loans. The Cabinet of Ministers of Ukraine has identified the Ministry of Finance to be in charge of the Program implementation. The Government of Ukraine and the National Bank of Ukraine will continue to implement a comprehensive financial sector program that aims to rehabilitate the financial system and minimize the potential for a wide scale disruption in the financial sector and the overall economy.

Building on the reforms supported by FSDPL1 and FSDPL2, we will continue to strengthen the financial and operational capacity of the DGF. This includes continuing to ensure that the DGF has access to adequate back-up funding. We will also implement the changes needed to improve the speed of depositor payout and asset recovery following the legal and other changes supported by FSDPL1 and FSDPL2.

We will continue to ensure the solvency of the banking system by utilizing the revised diagnostic studies supported by FSDPL2 for the top 20 banks. Following the results of the studies, we will put in place bank recapitalization programs for those banks that are found to be undercapitalized. We will also ensure that all banks except for SIBs are resolved on a least cost basis. For SIBs, any resolution will be done in a transparent way that minimizes the threats to financial stability and which is grounded in the legal framework supported by FSDPL2.

Utilizing the legal and regulatory reforms supported by FSDPL1 and FSDPL2, we will continue to strengthen the legal and institutional framework for the banking system to improve its resiliency and efficiency. In particular, following the launch of the diagnostic on related party lending in the banking sector supported by FSDPL2, we will aim to complete the diagnostic and put in place related party lending unwinding plans for those banks found to have above-limit related party exposures.

Considering the above, the Government of Ukraine asks the World Bank to support reforms under the Second Programmatic Financial Sector Development Policy Loan in the amount of USD 500 million to facilitate the stabilization of the banking sector and lay the groundwork for the restructuring of the financial sector.

Prime Minister of Ukraine **Arseniy YATSENYUK**

Governor of the National Bank of Ukraine **Valeriya GONTAREVA**

ANNEX 3: FUND RELATIONS ANNEX

Press Release No. 15/364
July 31, 2015

The Executive Board of the International Monetary Fund (IMF) today completed the first review of Ukraine's Extended Arrangement under the Extended Fund Facility (EFF). The completion of this review enables the disbursement of SDR 1,182.1 million (about US$1.7 billion), which would bring total disbursements under the arrangement to SDR 4.72 billion (about US$6.68 billion).

Ukraine's four-year SDR 12.348 billion (about US$17.5 billion) EFF was approved on March 11, 2015 (see Press Release No. 14/189) to support the government's economic program, which aims to put the economy on the path to recovery, restore external sustainability, strengthen public finances, maintain financial stability, and support economic growth by advancing structural and governance reforms, while protecting the most vulnerable.

Following the Executive Board's discussion, Mr. David Lipton, First Deputy Managing Director and Acting Chair, said:

"The Ukrainian economy remains fragile, but encouraging signs are emerging. In recent months, the exchange rate has stabilized, domestic-currency retail deposits have been increasing, and the pace of economic decline is moderating. Continued prudent policies and further reforms should allow the economy to turn the corner and growth to resume in the period ahead.

"Since the approval of a financial arrangement under the IMF's Extended Fund Facility, the authorities have made a strong start in implementing their economic program. The momentum needs to be sustained, as significant structural and institutional reforms are still needed to address economic imbalances that held Ukraine back in the past.

"Maintaining an appropriately tight monetary policy and building up official foreign exchange reserves will be critical to entrench external stability and anchor inflation expectations. As disinflation takes root, monetary policy can be carefully eased to support economic activity. Removal of administrative measures on foreign exchange operations should proceed in a gradual and sequenced manner, once the enabling conditions are in place.

"Restoring a sound banking system is key for economic recovery. To this end, the strategy to strengthen banks through recapitalization, reduction of related-party lending, and resolution of impaired assets should be implemented decisively.

"The authorities recognize that continued fiscal discipline is needed to reduce risks and strengthen public finances. Strong political support should be mobilized to sustain budgetary consolidation and energy sector reforms going forward, while ensuring an adequate social safety net. At the same time, restoring debt sustainability will require the completion of a debt operation consistent with program objectives. The authorities and the holders of their sovereign debt should continue their efforts to reach an agreement ahead of the next program review. In the event that talks with private creditors stall, and Ukraine determines that it cannot service this debt, the Fund could continue to lend to Ukraine consistent with its Lending-into-Arrears Policy.

"Further substantial progress with structural reforms is essential to enable strong recovery of private activity. In this regard, efforts to fight corruption, improve the business climate, and reform state-owned enterprises should be stepped up."

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