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Project Information Document (PID)

Concept Stage | Date Prepared/Updated: 20-May-2019 | Report No: PIDC25981

BASIC INFORMATION

A. Basic Project Data

Country	Project ID	Parent Project ID (if any)	Project Name
Bulgaria	P168133		Bulgaria - Deposit Insurance Contingency Financing Project (P168133)
Region	**Estimated Appraisal Date**	**Estimated Board Date**	**Practice Area (Lead)**
EUROPE AND CENTRAL ASIA	Nov 14, 2019	Feb 20, 2020	Finance, Competitiveness and Innovation
Financing Instrument	**Borrower(s)**	**Implementing Agency**	
Investment Project Financing	Bulgarian Deposit Insurance Fund	Bulgarian Deposit Insurance Fund	

Proposed Development Objective(s)

The Project Development Objective is to strengthen Bulgaria's financial sector safety net by enabling contingent financing to the Bulgarian Deposit Insurance Fund, in order for it to meet potential deposit insurance and bank resolution obligations.

PROJECT FINANCING DATA (US$, Millions)

SUMMARY

Total Project Cost	400.00
Total Financing	400.00
of which IBRD/IDA	400.00
Financing Gap	0.00

DETAILS

World Bank Group Financing

International Bank for Reconstruction and Development (IBRD)	400.00

Environmental and Social Risk Classification	Concept Review Decision

Low	Track I-The review did authorize the preparation to continue

Other Decision (as needed)

B. Introduction and Context

Country Context

A vibrant private sector has helped improve economic performance above expectations; this has been also supported by improvements in the fiscal position. GDP growth accelerated to 3.7% in 2016-18, due in part to a dynamic export sector which took advantage of improving external conditions and an expanded share in global trade. Fiscal accounts ran a surplus in 2016-18 as a result of improved revenue collection and slower implementation of EU funded public investment. Tax revenues reached 30% of GDP in 2018, up by 1.1 percentage point of GDP compared to 2015 thanks to strong economic activity, better compliance, and higher minimum wages. Prudent fiscal policy contributed to substantial reduction in public debt levels, and an upgrading by S&P at the end of 2017 of Bulgaria's long-term credit rating to investment grade (BBB-), while Fitch raised the credit rating from BBB- to BBB+.

Wage growth and EU-funded investment are expected to continue to drive economic growth. Bulgaria's growth momentum is expected to remain strong, mainly driven by solid domestic demand. Real wage growth will continue to stimulate private consumption. High demand, increased capacity utilization and EU funding are set to boost investment, while imports should outpace exports, leading to a further reduction in the current account surplus. Overall, real GDP growth is expected to strengthen to 3.6% in 2019 as well as in 2020.

Sectoral and Institutional Context

i. Banking Sector Structure and Performance

The banking system is primarily foreign owned, although with a sizeable domestically owned segment. There are 25 banks operating in the country, 17 of which are majority foreign-owned (12 are subsidiaries of foreign banks, and 5 are branches of foreign banks), all of them representing 77.2 percent of total bank assets as of end-2018. There is one state-owned bank, the Bulgarian Development Bank, representing 2.9 percent of total assets. The top five banks in Bulgaria have a market share of 59.4 percent of total bank assets, with the largest two owned by Italian and Hungarian parents, with 18.4 percent and 13.7 percent market shares, respectively. There are 7 domestically owned private banks with a combined asset share of 19.9 percent, including the fourth largest bank (First Investment Bank (FIB)).

There have been material changes in the structure of the Bulgarian banking sector over the past 4 years, most notably, the exit of Greek-owned banks. As of end-2014, Greek-owned banks represented the largest share of the banking sector, with almost a quarter of total bank assets. Since then, and as a result of mergers, the asset share of Greek banks has reduced to 2.8%, and when the regulator gives final approval to the sale of Piraeus Bank[1], there will not be any majority Greek-owned banks in Bulgaria. Belgian-owned CIBANK merged with Greek-owned United Bulgarian Bank (UBB) in 2018, with the new UBB becoming the third largest bank in the country. Preliminary approval was given to

[1] In November 2018, foreign-owned Eurobank (which itself used to be a Greek-owned bank) announced that it had agreed to buy Piraeus Bank, a deal that was preliminary approved by the Bulgarian regulator on March 28, 2019. Eurobank also absorbed Greek-owned Alpha Bank in 2016.

the sale of French-owned Societe Generale Expressbank to Hungarian-owned DSK, after which DSK will likely become the largest bank in the country.

Figure 1. Asset share of banks, 2018

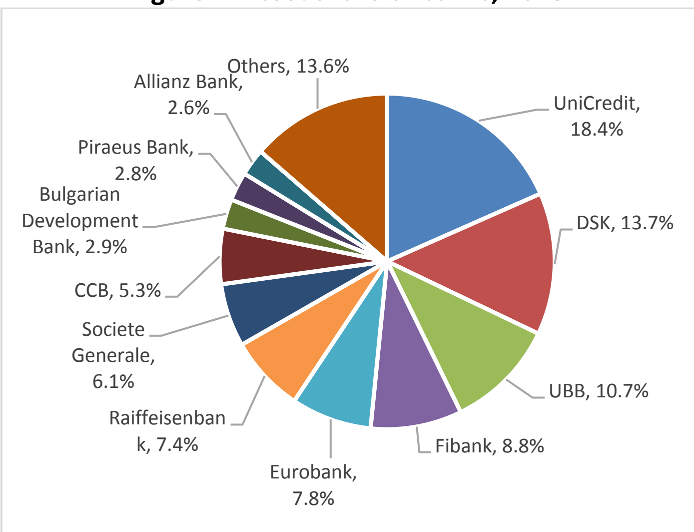
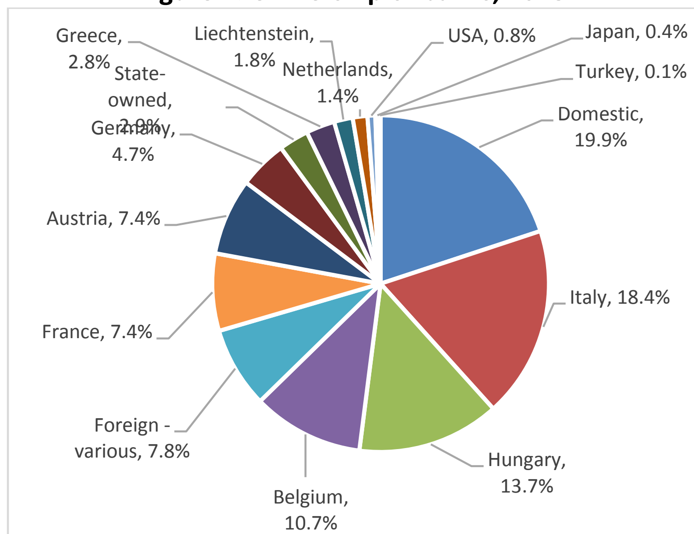


Figure 2. Ownership of banks, 2018



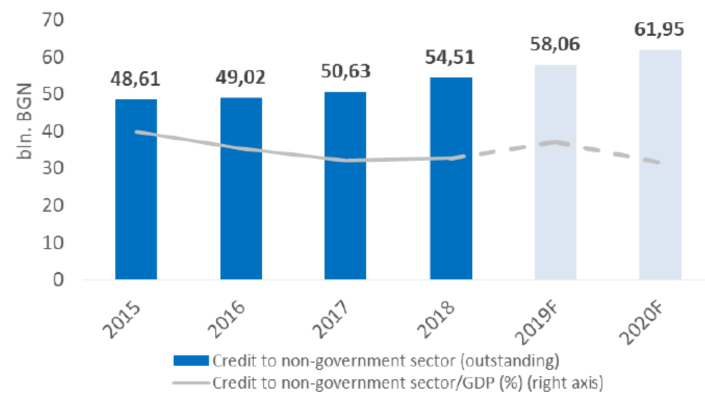
Source: BNB, WB staff calculations

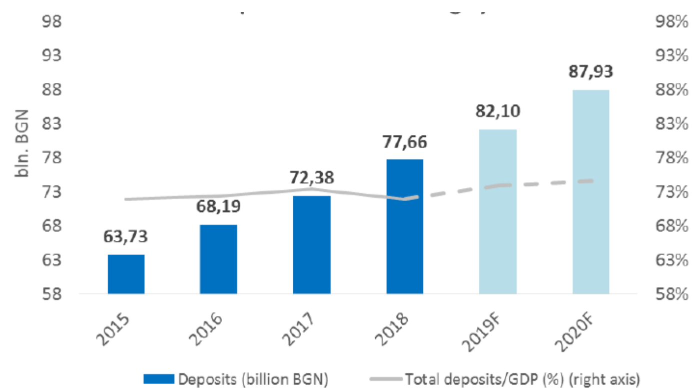
2018 was characterized by a sizeable credit growth. The total outstanding amount of loans to the private sector (non-financial corporations and households) rose from BGN 50.6 billion in 2017 to BGN 54.5 billion in 2018, driven by the improved economic environment and increases in household income. Private credit to GDP increased from 50.1% in 2017 to 50.5% in 2018. Almost 65% of loans are denominated in local currency, while another 28.6% are denominated in euro, to which the local currency is pegged to.

Strong deposit growth continues to drive lending. Funding appears relatively comfortable, driven mostly by a significant increase in deposits. As of end-2018, the total amount of outstanding deposits in the banking system reached BGN 77.7 billion, representing an annual growth of 7.3% despite the low interest rate levels, and compared to an annual growth rate of 6.2% in 2017. Both households and non-financial corporations continued to place deposits mainly in domestic currency, signaling a sustained confidence effect. More than 65% of deposits were denominated in local currency, while 34.6% were denominated in euro. The share of deposits to GDP was 72% at the end of 2018, compared to 71.6% in 2017.

Figure 3. Credit to the private sector

Figure 4. Deposits in the banking system





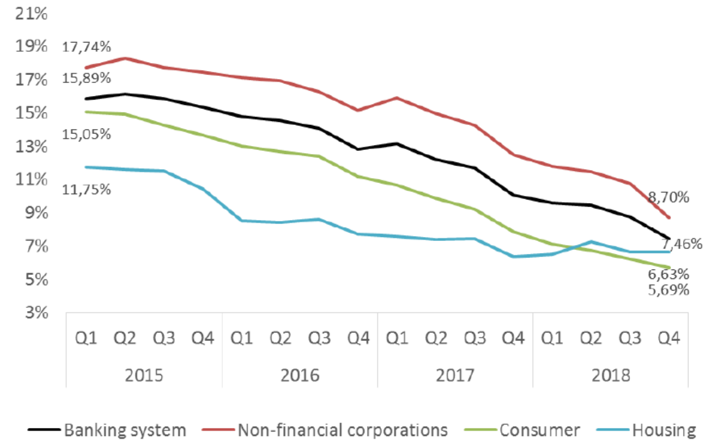
Source: Association of Banks in Bulgaria

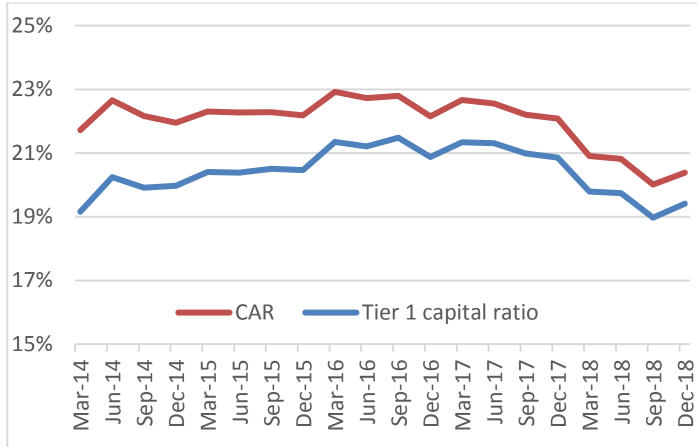
Despite improvements, NPLs of non-financial corporations remain relatively high for EU standards. As of end-2018, the NPL ratio of the banking system had dropped to 7.5% from 10.1% at the end of 2017, the lowest ratio since 2009 and significantly below the peak of almost 19% in late 2014. Provisions to NPLs stood at 60.1%. NPLs of non-financial corporations declined to 8.7% in 2018, compared to 12.5% in 2017, while those of housing and consumer loans stood at 6.6% and 5.7% respectively. While this represent a significant downward trend, NPLs levels are still above the EU average of 3-4%.

Banking sector capital adequacy and profitability are generally strong. The capital position of the banking sector is well above regulatory requirements[2], although this masks significant variation between individual banks. As of end-2018, the total capital adequacy ratio (CAR) decreased to 20.4% from 22.1% in 2017, while the Tier 1 capital ratio declined to 19.4% from 20.6% in 2017. According to the Bulgarian National Bank (BNB), the decrease in capital ratios was due to regulatory changes, including the implementation of the International Financial Reporting Standard 9 (IFRS 9), an increase in the total amount of the risk exposures and a decline in the total equity capital. The capital adequacy ratio is above the average level reported for European banks which, according to the ECB, was 17.8% at the end of Q3 2018. In terms of profitability, ROA and ROE of the banking sector stood at 1.6% and 12.1% respectively, compared to 1.2% and 9.3% in 2017, respectively.

Figure 5. Non-performing loans **Figure 6. Capital ratios**

[2] The minimum total CAR is set at 8%, while the minimum Tier 1 capital ratio is 6%, and the minimum Core Equity Tier 1 capital ratio is set at 4.5%. In addition to these, the BNB has set up other capital buffers: i) a capital conservation buffer of 2.5%, ii) a systemic risk buffer of 3%, iii) a countercyclical capital buffer (for credit risk exposures) of 0.5% in 2019 and 1% for 2020, and iv) a buffer for other systemically important institutions (applicable to ten banks identified as such by the BNB) of 0.25% to 0.75% for 2019, and of 0.5% to 1% for 2020.





Source: Association of Banks in Bulgaria

ii. Government Measures to Preserve Banking Sector Stability

In June 2014, Corporate Commercial Bank (KTB) – the 4th largest bank at the time – was put under a lengthy conservatorship after a large deposit run, a period during which KTB depositors did not have access to their savings. According to the existing legislation at the time, the Bulgarian Deposit Insurance Fund (BDIF) could only start reimbursing depositors once the banking license of a failed institution was withdrawn. This clause, and the absence of a back-up funding mechanism for the BDIF, led to a five months delay with payment to insured depositors. The BNB finally revoked KTB's license in November 2014 on the basis of its insolvency, thus triggering the payment of KTB's BGN 3.8 billion (€1.9 billion) of insured deposits (for up to BGN 196,000, or €100,000 per deposit account) by the BDIF, and KTB entered into bankruptcy procedures under the BDIF's oversight.

The repayment of KTB's insured deposits put a severe strain on BDIF's financial capacity, prompting the Government to request support from the World Bank. Prior to KTB's failure, the BDIF had accumulated total reserves of BGN 2.1 billion (€1.07 billion). In order to bridge the funding gap, in December 2014 the Government provided the BDIF with a loan of BGN 1.675 billion (€837.5 million), with a maturity of 5.5 years, at a fixed interest rate of 2.95%. At the same time, since the BDIF reserves were fully depleted after the payment to insured depositors, the Government requested support from the World Bank (and the EBRD) to rebuild the BDIF reserves. Box 1 provides more details on the World Bank response to this request.

Box 1. The World Bank's Deposit Insurance Strengthening Project (P154219)

Following the banking crisis of 2014, the Government requested urgent support from the World Bank to mitigate its consequences. The World Bank was able to offer a customized solution to the country needs by offering, in a timely manner, the combination of a loan to the BDIF and a FSAP Update (performed jointly with the IMF). The loan was instrumental in rebuilding the reserves of the BDIF (together with a parallel loan from the EBRD, see below), while the FSAP assessed and helped improve the authorities' crisis response, including the role of the deposit insurance scheme from the perspective of international and EU good practice.

A pivotal part of this support was the Deposit Insurance Strengthening Project, the first lending operation in Bulgaria in seven years. This project contributed to financing the BDIF following a results-based approach with financing made available to the BDIF in several tranches based on the achievement of 10 Disbursement Linked Indicators (DLIs) that measure progress towards the project development objective. The EUR 300 million loan was approved by the Board in March 2016 and declared effective in June 2016. To date, the entire amount has been disbursed.

The project development objective is to strengthen the financial and institutional capacity of the BDIF so as to enable to meet its deposit insurance and bank resolution obligations. The project has helped restoring the public confidence in the banking system by promptly replenishing reserves of the deposit insurance fund. In addition, the World Bank intervention has helped strengthening the BDIF's institutional capacity based on the lessons from the 2014 banking crisis, the findings of the World Bank 2015 assessment against the IADI's Core Principles for Effective Deposit Insurance Systems (an advanced module of the FSAP), and in line with the EU DGSD and BRRD.

This project was the World Bank's first ever operation with a deposit insurance fund acting as the Borrower. The World Bank's innovative approach combined funding on attractive terms with knowledge transfer in a critical area to ensure financial stability and contribute to the effective functioning of the financial sector going forward.

The failure of KTB exposed weaknesses in bank supervision and resolution regime. The crisis revealed institutional and supervisory weaknesses in the BNB as it failed to take action prior to the collapse of the bank, despite ample signals of the bank's aggressive and unsafe practices. It also gave rise to doubts about the health of other parts of the financial sector, particularly of other domestically owned banks[3]. Finally, the crisis exposed a number of deficiencies in the legal and institutional framework for bank resolution and deposit insurance and depleted the reserves of the BDIF.

Authorities have pursued a wide-ranging strategy to address weaknesses in regulatory and supervisory framework exposed by the 2014 banking crisis. The asset quality review (AQR) and stress tests of 2016 of the entire banking, insurance and pension sectors, conducted by Bulgarian authorities, showed that both the banking system and non-bank financial institutions were overall resilient. At the same time, two domestically-owned banks were shown to require larger capital buffers, and committed to implement the remedial action plans, including an effort to bring new investors. A new legal framework for bank resolution and deposit insurance, consistent with the EU Deposit Guarantee Schemes Directive (DGSD) and the EU Bank Recovery and Resolution Directive (BRRD), has been enacted and is being operationalized. Governance and independence of both regulators (the BNB and the Financial Supervision Commission - FSC) has been strengthened. Amendments to the Banking Law strengthened the definition of related-party exposures

[3] The failure of KTB in 2014 triggered an immediate run on deposits on the largest domestically owned bank (third largest in the country at that time). The situation was stabilized thanks to the prompt response by the authorities, including a large emergency liquidity assistance loan from the Government to the bank.

and tightened the control over related party exposures, a long-standing risk for domestically owned banks. Based on the recommendations from the BCP Assessment conducted by the IMF and the WB (advanced module of the FSAP), the BNB adopted and largely implemented an action plan to strengthen its bank supervision functions.

In mid-2018 the Government adopted a comprehensive action plan that includes measures to further strengthen financial sector stability and governance of institutions. The implementation of this action plan is seen as the essential pre-condition for Bulgaria's joining the EU's Exchange Rate Mechanism II (ERMII). In particular, the authorities started preparations for entering the European Banking Union by engaging into close cooperation mechanism with the ECB, with one of the entry requirements being a comprehensive AQR and stress test of selected banks operating in Bulgaria. Six banks are included in this assessment: the three largest (and foreign-owned) banks (Unicredit Bulbank, DSK Bank and United Bulgarian Bank), and three domestically owned banks (First Investment Bank, Central Cooperative Bank, and Investbank). The exercise is being conducted by the ECB and expected to be completed by July 2019. Any detected vulnerabilities would need to be addressed through implementation of bank-specific remedial action plans.

Relationship to CPF

The proposed Project is fully consistent with the Country Partnership Framework (CPF) for Bulgaria for the period FY17-FY22. The first Pillar of the CPF – Strengthening Institutions for Sustainable Growth – includes the Objective of Improved Resilience and Stability of the Financial Sector. Under this Objective, the CPF recognizes the pivotal role of the World Bank's support to the BDIF in bolstering its institutional and financial capacity to ensure deposit insurance and bank resolution obligations are met fully and on time. Moreover, the Performance and Learning Review of the CPF (just completed) states that this Objective remains highly relevant, and acknowledges that, given still nascent efforts to implement a pan-European Deposit Insurance Mechanism, having access to contingent financing will make the institutional underpinnings of the financial sector more robust, making it less reliant on a public bailout in the event of a crisis. A key outcome from the World Bank support under this CPF Objective is an effective safety net that will support confidence of depositors and increase the resilience of the banking system to possible shocks thereby ensuring a steady increase in domestic savings that can be channeled into productive investments.

C. Proposed Development Objective(s)

The Project Development Objective is to strengthen Bulgaria's financial sector safety net by enabling contingent financing to the Bulgarian Deposit Insurance Fund, in order for it to meet potential deposit insurance and bank resolution obligations.

Key Results (From PCN)

The proposed Project is expected to further bolster banking sector stability in Bulgaria, by offering a contingent financing facility to the BDIF during the course of the Project. Thus, in case of need, the proposed Project will ensure adequate financial capacity of the BDIF to meet its deposit insurance and bank resolution obligations in a timely manner, while reducing the risk of using state budget resources.

Legal Operational Policies	Triggered?
Projects on International Waterways OP 7.50	No
Projects in Disputed Areas OP 7.60	No

Summary of Screening of Environmental and Social Risks and Impacts

The project will provide contingent financing to BDIF so that it can meet its obligations as bank deposit insurer. The project is expected to have positive impacts on domestic and commercial savings by protecting them from losses in the event of bank failure. Protection of deposits is particularly significant for households with low liquid assets, thus having an even higher impact on poor households. Project will not fund civil works, not procure goods and no impacts on private land and assets are anticipated. No direct nor indirect employment for the purpose of performing project activities is expected. Given the low risk nature of the intervention, the absence of major social and environmental risks and impacts, the project’s environmental and social risk is considered to be low.

Note To view the Environmental and Social Risks and Impacts, please refer to the Concept Stage ESRS Document**.**

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