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PROJECT PERFORMANCE ASSESSMENT REPORT



UKRAINE

First and Second Programmatic
Financial Sector Development
Policy Loan

Report No. 144601

DECEMBER 24, 2019

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PROJECT PERFORMANCE ASSESSMENT REPORT
UKRAINE
FIRST PROGRAMMATIC FINANCIAL SECTOR DEVELOPMENT POLICY LOAN
(IBRD 84220)
SECOND PROGRAMMATIC FINANCIAL SECTOR DEVELOPMENT POLICY
LOAN
(IBRD 85370)

December 24, 2019

Financial, Private Sector, and Sustainable Development

Independent Evaluation Group

Currency Equivalents (annual averages)

Currency Unit = Ukrainian hryvnia (Hrv) as of December 31 of year (except 2019)

2007	\$1.00	Hrv 5.07
2008	\$1.00	Hrv 7.62
2013	\$1.00	Hrv 8.13
2014	\$1.00	Hrv 15.80
2015	\$1.00	Hrv 23.95
2019 (April 30)	\$1.00	Hrv 26.40

Abbreviations

CAR	capital adequacy ratio
CPS	Country Partnership Strategy
DGF	Deposit Guarantee Fund
DPL	development policy loan
EBRD	European Bank for Reconstruction and Development
EU	European Union
GDP	gross domestic product
Hrv	hryvnia (Ukrainian currency)
IEG	Independent Evaluation Group
IMF	International Monetary Fund
NBU	National Bank of Ukraine
NPL	nonperforming loans
PDO	project development objective
PPAR	Project Performance Assessment Report

All dollar amounts are U.S. dollars unless otherwise indicated.

Fiscal Year

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Paul Holden (with the guidance of Andrew Stone) assessed the project in April 2019 and prepared this report. Jeff Chelsky peer reviewed the report and Fernando Manibog panel reviewed it. Alla Bilun in the World Bank Ukraine Office provided excellent administrative support. Emelda Cudilla formatted and finalized the report. Ozlem Onerci and Izlem Yenice participated in the mission to Ukraine and provided valuable inputs. Stefan Apfalter was involved in the early phase of this work.

Principal Ratings

Indicator	ICR	ICR Review	PPAR
Outcome	Satisfactory	Satisfactory	Satisfactory
Risk to development outcome	Substantial	Substantial	High
Bank performance	Satisfactory	Satisfactory	Satisfactory
Borrower performance	Satisfactory	Satisfactory	Moderately satisfactory

Note: The Implementation Completion and Results Report (ICR) is a self-evaluation by the responsible Global Practice. The ICR Review is an intermediate Independent Evaluation Group product that seeks to independently validate the findings of the ICR. PPAR = Project Performance Assessment Report.

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About This Report

The Independent Evaluation Group (IEG) assesses the programs and activities of the World Bank for two purposes: first, to ensure the integrity of the World Bank's self-evaluation process and to verify that the World Bank's work is producing the expected results, and second, to help develop improved directions, policies, and procedures through the dissemination of lessons drawn from experience. As part of this work, IEG annually assesses 20–25 percent of the World Bank's lending operations through fieldwork. In selecting operations for assessment, preference is given to those that are innovative, large, or complex; those that are relevant to upcoming studies or country evaluations; those for which executive directors or World Bank management have requested assessments; and those that are likely to generate important lessons.

To prepare a Project Performance Assessment Report (PPAR), IEG staff examine project files and other documents, visit the borrowing country to discuss the operation with the government and other in-country stakeholders, interview World Bank staff and other donor agency staff both at headquarters and in local offices as appropriate, and apply other evaluative methods as needed.

Each PPAR is subject to technical peer review, internal IEG panel review, and management approval. Once cleared internally, the PPAR is commented on by the responsible World Bank Country Management Unit. The PPAR is also sent to the borrower for review. IEG incorporates both World Bank and borrower comments as appropriate, and the borrower's comments are attached to the document sent to the World Bank's Board of Executive Directors. After an assessment report is sent to the Board, it is disclosed to the public.

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IEG's use of multiple evaluation methods offers both rigor and a necessary level of flexibility to adapt to lending instrument, project design, or sectoral approach. IEG evaluators all apply the same basic method to arrive at their project ratings. Following is the definition and rating scale used for each evaluation criterion (additional information is available on the IEG website: <http://ieg.worldbankgroup.org>).

Outcome: The extent to which the operation's major relevant objectives were achieved, or are expected to be achieved, efficiently. The rating has three dimensions: relevance, efficacy, and efficiency. *Relevance* includes relevance of objectives and relevance of design. Relevance of objectives is the extent to which the project's objectives are consistent with the country's current development priorities and with current World Bank country and sectoral assistance strategies and corporate goals (expressed in Poverty Reduction Strategy Papers, Country Assistance Strategies, sector strategy papers, and operational policies). Relevance of design is the extent to which the project's design is consistent with the stated objectives. *Efficacy* is the extent to which the project's objectives were achieved, or are expected to be achieved, taking into account their relative importance. *Efficiency* is the extent to which the project achieved, or is expected to achieve, a return higher than the opportunity cost of capital and benefits at least cost compared with alternatives. The efficiency dimension is not applied to development policy operations, which provide general budget support. *Possible ratings for outcome:* highly satisfactory, satisfactory, moderately satisfactory, moderately unsatisfactory, unsatisfactory, and highly unsatisfactory.

Risk to development outcome: The risk, at the time of evaluation, that development outcomes (or expected outcomes) will not be maintained (or realized). *Possible ratings for risk to development outcome:* high, significant, moderate, negligible to low, and not evaluable.

Bank performance: The extent to which services provided by the World Bank ensured quality at entry of the operation and supported effective implementation through appropriate supervision (including ensuring adequate transition arrangements for regular operation of supported activities after loan or credit closing toward the achievement of development outcomes). The rating has two dimensions: quality at entry and quality of supervision. *Possible ratings for Bank performance:* highly satisfactory, satisfactory, moderately satisfactory, moderately unsatisfactory, unsatisfactory, and highly unsatisfactory.

Borrower performance: The extent to which the borrower (including the government and implementing agency or agencies) ensured quality of preparation and implementation and complied with covenants and agreements toward the achievement of development outcomes. The rating has two dimensions: government performance and implementing agency(ies) performance. *Possible ratings for borrower performance:* highly satisfactory, satisfactory, moderately satisfactory, moderately unsatisfactory, unsatisfactory, and highly unsatisfactory.

Preface

This Project Performance Assessment Report evaluates a programmatic series of two development policy operations for Ukraine consisting of loans in the amount of \$500 million for the first development policy loan (DPL1) (IBRD-84220), approved by the World Bank on August 7, 2014, and \$500 million for DPL2 (IBRD-85370), approved by the World Bank on September 15, 2015. DPL1 closed on November 30, 2014, and DPL2 closed on June 30, 2016. Both operations were fully disbursed.

The project development objectives of the Ukraine First and Second Programmatic Financial Sector Development Policy Loans (DPL1 and DPL2) were to (i) strengthen the financial, operational, and regulatory capacity of the Deposit Guarantee Fund for the resolution of insolvent banks; (ii) improve the solvency of the banking system through the implementation of bank recapitalization and restructuring plans and timely enforcement action; and (iii) strengthen the legal and institutional framework to improve resiliency and efficiency of the banking system.

The findings of this report are based on in-depth reviews of program documents, International Monetary Fund reports, discussions with World Bank staff, and interviews with government officials, private sector operators, and other stakeholders that occurred during an evaluation mission to Kiev, Ukraine, in April 2019. The Independent Evaluation Group gratefully acknowledges the cooperation and assistance of all those consulted, and the excellent assistance provided by World Bank staff in the country office in Kiev.

Following standard Independent Evaluation Group procedures, IEG requested the Country Director share the report with the borrower for comments. No comments were received.

Summary

This Project Performance Assessment Report evaluates a programmatic series of two development policy loans (DPLs) to Ukraine of \$500 million each that were provided as part of an urgent international effort to assist the country when Ukraine's financial sector teetered on the edge of collapse in 2014. A perfect storm had affected the financial system when the geopolitical situation had descended into deep crisis arising from the Euromaidan political upheaval, the Russian Federation's annexation of Crimea, and the armed separatist movement in the eastern part of the country that initiated open, armed conflict that at times resembled a full-scale war. The exchange rate virtually halved between the end of 2013 (Hrv 8.13 to 1 U.S. dollar) and the end of 2014 (Hrv 15.8 to 1 U.S. dollar), inflation accelerated to 24 percent, the public sector fiscal deficit exceeded 10 percent of gross domestic product (GDP), and public debt—including guarantees—spiked to 70 percent of GDP.

The financial sector had undergone significant deleveraging during 2008–12, with outstanding loans owed to the banking system declining from 83.4 percent of GDP at the end of 2008 to 57.8 percent at the end of 2012. However, many of the remaining outstanding commercial bank loans were of questionable soundness because of widespread related party lending and even outright fraud. Although deposits had risen significantly because many banks offered high interest rates, many of those interviewed in Ukraine, both within government and in the private sector, described banking practices in many commercial banks over this period as “Ponzi schemes” with high interest rates attracting depositors and many banks relying on new deposits to pay interest on existing ones while funds were diverted to related party lending or even transferred to bank accounts outside the country. Furthermore, there was little attempt to address the fact that nonperforming loans (NPLs), a holdover from the 2008 crisis, still constituted one-quarter of the banking system's assets as of end 2013.

During 2008–13, a substantial portion of commercial banks' lending had been denominated in foreign currency, primarily because foreign currency lending rates were much lower than those denominated in hryvnia. Foreign currency deposits had also grown, which exposed both borrowers and commercial bank lenders to the risk of significant increases in amounts owed if the hryvnia depreciated. When the exchange rate collapsed, NPLs increased substantially.

Interest in fundamental reform that would have resolved many of the problems underlying the 2008 crisis had weakened over the same period. As a result, financial supervision was weak and ignored the problems that could arise if either internal or external shocks occurred.

The structural weaknesses in the financial sector were exposed suddenly and brutally in 2014 and led to large numbers of bank failures. During 2014–15, the banking system lost more than 50 percent of foreign currency–denominated deposits and 29 percent of hryvnia-denominated deposits. By June 2015, 54 banks (over a third of all banks) had failed.

Donors responded rapidly. The World Bank DPL operations were part of an extensive package of assistance—led by the International Monetary Fund with the participation of the European Union and several bilateral donors—which was provided to assist Ukraine in weathering the severe financial crisis that emerged. Assistance aimed to prevent systemic collapse of the financial system, and the World Bank took the lead in financial sector reform efforts.

Project Development Objectives

The project development objectives (PDOs) of the DPL series were (i) PDO1—to resolve insolvent banks by strengthening the financial, operational, and regulatory capacity of the Deposit Guarantee Fund (DGF); (ii) PDO2—to improve the solvency of the banking system through the implementation of bank recapitalization and restructuring plans and timely enforcement action; and (iii) PDO3—to improve the resiliency and efficiency of the banking system by strengthening its legal and institutional framework.

World Bank support under the two DPLs and the concomitant development objectives were **highly relevant** in supporting Ukraine in response to these shocks because the outflow of deposits threatened a bank panic that could have led to a financial meltdown. By focusing on financial sector reform, the DPLs were also an important component of the multidonor support program. The policy component of the DPL series was the centerpiece of the reform agenda for the financial sector. In addition, the PDOs and the reform policies that were part of the prior actions were aligned with both the World Bank and the government’s reform strategy.

The relevance of design was **substantial** given the urgency associated with the dire nature of the macro financial crisis in Ukraine. The pillars of the program were identical to the PDOs. The prior actions incorporated many of the measures that had not been taken in the previous crisis but were implemented in 2014–16, including greatly strengthened supervision processes, a bank resolution framework, stress testing of banks, and strict recapitalization rules. Although the urgency in tackling the crisis is acknowledged, there were also weaknesses in the causal chain, which may affect the financial system in the longer term. The first was the extent to which state-owned banks, some of which were systemically important, would become a central problem in the financial system. The second was the extent to which the contracting framework would be subject to outside pressure. However, these omissions were understandable given the

need to focus on the immediate crisis response, which overshadowed these medium-term concerns.

The prior actions under PDO1 contributed significantly to mitigating the impact of the crisis on the banking system. Additional pressure on the financial system in 2015 resulted from a further sharp fall in the exchange rate (to Hrv 23.95 to 1 U.S. dollar). Under DPL2, further modifications were made to the prior actions that were aimed at addressing the deteriorating situation and bolstering support for the financial sector through strengthening the capacity of the DGF and the National Bank of Ukraine (NBU) to address the intensification of the crisis. Although these measures were coordinated with other donors, the World Bank lead regarding technical analysis and support in the financial sector seemed decisive, and achievements under PDO1 are rated **substantial**.

Achievements under PDO2 were **substantial**. The prior actions embodied in the second policy pillar significantly supported the achievement of PDO2 by strengthening the NBU's role in identifying problem banks in a timely way, developing recapitalization plans, and undertaking ongoing diagnostic studies under circumstances in which pressure on the financial system was raising systemic risks. These measures, supported by the World Bank through the DPL series, bolstered confidence and reduced risks. As a result, substantial progress was achieved in returning the remaining private banks to financial soundness. By end-2018, NPLs of private commercial banks had fallen to 10 percent, all of which had been fully provisioned.

PDO3 achievements were **modest**. This PDO aimed to address longer-term institutional reform issues that had not been resolved after the 2008–10 crisis. They were aimed at strengthening the legal and institutional framework to buttress the resiliency of the banking system in dealing with shocks and to improve its efficiency. State-owned banks were subject to stress tests and capitalization reviews. However, there was a lack of focus on the legal implications of the difficulty of dealing with the NPLs of the state-owned banks. This issue was brought into sharp focus after the closing of DPL2, when, in December 2016, the largest private bank in the country, PrivatBank, was found to be insolvent and was nationalized, resulting in a doubling of the NPLs in the financial system. Because of laws relating to the disposition of state assets, the NPLs of the state-owned banks cannot be written down, which heightens the difficulty of privatizing any of them.

The DPL program's objectives are highly relevant to the country context and to the assistance strategies of the World Bank, the International Monetary Fund, and donors to Ukraine. The program's design is rated **substantial**. The DPL program largely achieved its first two development objectives, but achievement of the third objective was **modest**. The overall outcome of the DPL program is **satisfactory**.

The risk to development outcome in the financial sector is **high**. On the positive side, the DPL series contributed substantially to upgrading the regulatory system for the commercial banking sector in Ukraine. One of the most significant achievements of DPL1 and DPL2 was strengthening the regulatory and resolution capacity of both the NBU and the DGF for private sector banks. This contrasts with the aftermath of the 2008–10 crisis, when the appetite for regulatory reform diminished markedly after the immediate pressures of the crisis receded. A number of issues emerged, however, after the closing of DPL2, which present a sustainability risk. The most important are the following:

- The large share of state-owned banks in the financial system. By end 2016, domestic state-owned banks controlled more than 50 percent of total banking assets compared with 11 percent in 2008, primarily as a result of the nationalization of PrivatBank in December 2016, which represented a doubling of assets under state control. As of mid-2019, this share has hardly changed, which may expose the operation of the state-owned banks to political capture and influence from vested interests.
- Deep-seated political corruption and an unreliable and corrupt court and prosecutorial system. The court and prosecutorial systems are influenced strongly by vested interests, so there is little certainty that reliable, arm’s-length contracting can take place. Support for continued pursuit of fundamental reforms has wavered distinctly within certain sectors of government.
- Inadequate legislation governing the financial sector. The failure to pass or implement critical legislation governing the financial sector continues to hamper the full recovery of the financial system.
- The essentially unregulated insurance sector in Ukraine. The rapid growth of the lightly regulated nonbank financial sector after the strengthening of the powers of the NBU and the DGF over the banking sector suggests that vested interests could be attempting to circumvent regulation. For the stability, growth, and transparency of financial intermediation, regulation of nonbank financial intermediaries is also essential. This will be addressed by the “Split Law,” passed in the second half of 2019, which brings the sector under the regulatory authority of the NBU, but implementation will be key in determining its impact.
- The fragile financial state of the DGF poses a potential sustainability risk. Without decisive measures, the earliest the DGF could attain positive net equity would be in the 2030s. However, it is unlikely that the government would allow the DGF to fail.

Lessons

- **Close coordination among donors is critical for DPLs to maximize the effectiveness of a jointly designed reform program.** In this DPL series, close donor coordination ensured the reform program's consistency and the uniformity of advice regarding policy measures.
- **The design of DPLs needs to focus on all relevant issues, potential weaknesses, and gaps in reform measures.** The sustainability of outcomes in the long term relies on a continued focus on such reforms in follow-up operations.
- **The presence of task teams in the field can be a critical factor in promoting financial sector reform.** Country-based task team leaders can have local knowledge and the ability to engage closely with counterparts. This is an important element in planning succession.
- **Weak public understanding of financial sector reforms indicates a need to expand outreach efforts to enhance political sustainability.**
- **Sustainable reform is difficult to achieve in countries that have corrupt power structures and court systems.** Under such circumstances, it is an open question whether World Bank assistance risks providing additional resources for rent seeking rather than support for reforms.

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1. Background and Context

1.1 The 2014 financial crisis, which prompted the World Bank Financial Sector Development Policy Loan (DPL) series, had its roots in the imbalances leading to the earlier 2008 crisis. The 2000–07 period had been characterized by real gross domestic product (GDP) growth averaging more than 7 percent annually and by widening macroeconomic imbalances. Commercial bank lending had been rising by more than 40 percent per year over this period and accelerated to more than 70 percent in 2008. However, this had not raised significant concerns. Although the International Monetary Fund (IMF) 2008 Article IV report noted increasing risks from rising inflation, gas subsidies, and fiscal imbalances, it described Ukraine’s medium-term growth potential as “tremendous.”

1.2 As the effects of the 2008 global financial crisis spread around the world, it had severe negative effects on Ukraine’s economy. Demand for Ukraine’s steel exports fell sharply, and the country’s access to international capital markets reduced significantly. In October 2008 confidence in the banking system fell sharply, precipitating a large withdrawal of deposits. To increase confidence in the stability of the banking system, the National Bank of Ukraine (NBU) injected substantial amounts of liquidity. However, the crisis of confidence spread to the foreign exchange market and led to a large depreciation of the hryvnia. In 2009, the economy contracted by 15 percent in real terms.

1.3 The IMF approved a standby arrangement in late 2008, and the World Bank approved a DPL on December 22, 2008, accompanied by reforms to improve the investment climate and public finances, and a framework to strengthen the financial system. Part of the financial sector measures involved the introduction of legal and regulatory steps to promote the recapitalization and resolution of commercial banks.

1.4 At the outset of the crisis, state-owned banks accounted for less than 10 percent of the banking sector’s total assets. In 2009, the government nationalized 3 commercial banks, 1 of which was among the 20 largest banks in the country, raising the state’s stake in the domestic banking market to 19 percent of total assets by 2014. Furthermore, both private sector and public sector interviewees in Ukraine indicated that these nationalizations did not penalize former owners because they retained strong influence in the nationalized institutions and could influence their lending policies.

1.5 Over this period, 15 banks became insolvent, and the state recapitalized 3. Nonperforming loans (NPLs) rose to a peak of 40.3 percent in 2010, though they had fallen to 23.5 percent by 2013.

Box 1.1. Frequent Renegotiation of Support: IMF Assistance to Ukraine, 2008–19

In late 2008, the International Monetary Fund (IMF) negotiated with Ukraine an \$11 billion special drawing rights standby arrangement to assist in restoring financial and economic stability and bolstering confidence in the banking system, which occurred during 2009–10.^a However, by 2010, an expansionary budget gave rise to concern because the consensus for reform weakened, and the program went off track.

In mid-2010, the existing standby arrangement was canceled, and a new agreement was forged for \$15.1 billion to put the country on the path to fiscal sustainability, reform the gas sector, and provide continued support for the banking system. The underlying goal was that markets would finance the public sector deficit fully by 2011. Program requirements included structural reforms to the pension system and public administration, and a reduction in the public sector deficit. In addition, the gas sector would be modernized, and the financial viability of the state-owned gas company, Naftogaz, would be restored through tariff increases and a new price-setting mechanism.

By 2012, however, the IMF Article IV report indicated that policies had not been sufficient to attain key objectives, and important reforms had not occurred because of political pressures from vested interests.

By 2014, the economy was *again* in both political and economic crisis, and the IMF approved a \$17 billion standby arrangement aimed at improving macroeconomic stability, restoring growth, and strengthening economic governance and transparency. The program was undertaken in conjunction with other donors, particularly the World Bank, which provided the two development policy loans that are assessed in this Project Performance Assessment Report.

The IMF pointed out that the country's financial stability was threatened by the overvalued exchange rate, accompanied by fiscal deficits arising from loose fiscal policy, the loss of confidence in the banking system, and the need to finance Naftogaz's large losses. The new government was strongly committed to both macroeconomic and structural reforms, including dealing with corruption.

As the conflict in eastern Ukraine expanded, the government requested a longer period for reform and economic adjustment in 2015 and therefore requested cancellation of the standby arrangement and a new four-year arrangement under an extended fund facility (EFF) for \$17.5 billion while remaining committed to longer-term reform.^b

After asking for a number of waivers of conditionality under the EFF, Ukraine requested that the EFF arrangement be canceled and replaced by a new standby arrangement. The original agreement had a provision for 15 reviews over the period of the EFF. However, only three took place. The IMF agreed to cancel the EFF and replace it with a standby arrangement for \$3.9 billion, which was approved by the Fund's Executive Board in December 2018.

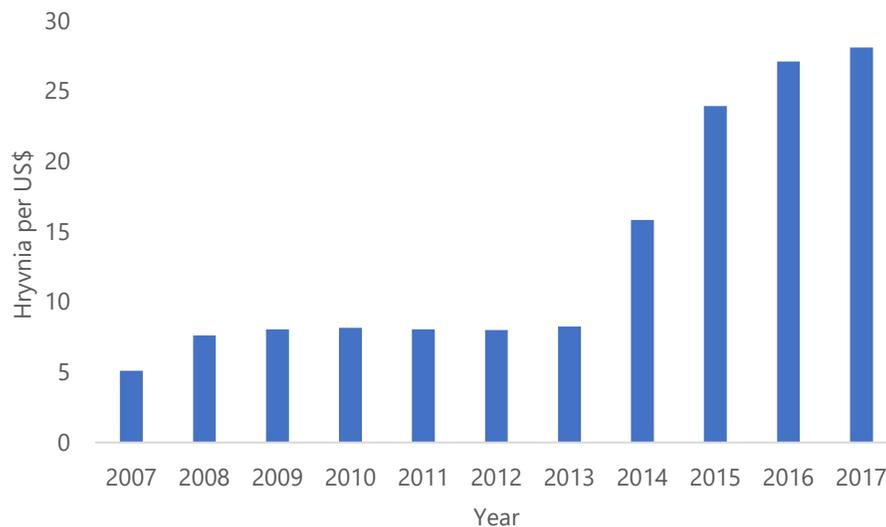
Note: a. An IMF standby arrangement provides member countries with funding to address short-term balance of payments difficulties. It focuses primarily on macroeconomic adjustment and normally covers a period of one to two years.

b. An EFF arrangement is an IMF lending facility that assists members in addressing macroeconomic imbalances arising from structural problems that require a longer period of adjustment than that provided by a standby arrangement. EFFs typically are for three to four years and generally focus on structural reforms.

1.6 The financial sector had undergone significant deleveraging during 2008–12, with outstanding loans owed to the banking system declining from 83.4 percent of GDP at the end of 2008 to 57.8 percent at the end of 2012. Deposits rose significantly because many banks offered high interest rates, although several of the foreign banks exited Ukraine. Many of those interviewed in Ukraine, both within government and in the private sector, described banking practices in many commercial banks over this period as “Ponzi schemes” with high interest rates attracting depositors and many banks relying on new deposits to pay interest on existing ones while providing loans to related parties or even transferring funds to bank accounts outside the country. Furthermore, there was little attempt to address the fact that NPLs still constituted one-quarter of the banking system’s assets as of end 2013.

1.7 During 2008–14, a substantial portion of commercial banks’ lending had been denominated in foreign currency, primarily because foreign currency lending rates were much lower than those denominated in hryvnia. This exposed both borrowers and commercial bank lenders to the risk of significant increases in amounts owed if the hryvnia depreciated. Bank regulators did not address the systemic risk inherent in these lending practices. When hryvnia depreciation finally occurred in 2014–17 (figure 1.1), it was a substantial contributor to the rapid growth of NPLs.

Figure 1.1. U.S. Dollar-Hryvnia Exchange Rate Units per U.S. Dollar, 2007–17



Source: <http://data.imf.org/regular.aspx?key=61545850>.

1.8 As the most pressing moments of crisis passed in 2010, the government’s determination to undertake deep-seated reform attenuated rapidly. As the 2010 IMF

paper *Request for Standby Arrangement and Cancellation of Current Arrangement* stated, “Against a difficult economic environment and a complex political situation, the program eventually went off track as policies weakened and reforms stalled in the run up to the presidential elections” (IMF 2010, 4).

1.9 During 2010–13, there was little interest in fundamental reform in Ukraine. Essentially, the factors that had caused the 2008–09 financial sector crisis were not addressed; thus, any substantial shock could have precipitated a further crisis. As the program document for the First Programmatic Financial Sector Development Policy Loan (DPL1) pointed out, “The authorities did not follow through with longer-term structural and institutional reforms needed to address deep-seated banking sector vulnerabilities such as a high level of NPLs, weak corporate governance in some banks, the high share of related party lending, and issues inhibiting the effectiveness of banking supervision” (World Bank 2014, 11).

1.10 The vulnerability to shocks was tested in 2014–15 with severe results for the banking system. First, Ukraine had suspended the association agreement with the European Union (EU) in November 2013, which contributed to political turmoil and widespread demonstrations that culminated in the ouster of President Viktor Yanukovich in the Euromaidan revolution in February 2014. Second, the Russian Federation annexed Crimea in March 2014. Third, war broke out in April 2014 in the Donbass region in eastern Ukraine as pro-Russia insurgents staged an uprising that led to armed conflict, substantial casualties, and outbreaks of open warfare.

1.11 The presidential election in May 2014 and the parliamentary elections in October 2014 generated further political uncertainty. This series of shocks resulted in a crisis of confidence in the banking sector—in the first six months of 2014, hryvnia deposits in the banking system declined by 12.6 percent and foreign currency deposits by 26.1 percent.

1.12 The outflows accelerated over the next 12 months and by June 2015, the banking system had lost 52 percent of foreign currency–denominated deposits and 29 percent of hryvnia-denominated deposits. As confidence in the banking system fell and the hryvnia exchange rate declined further,¹ there were additional widespread bank failures; by the end of June 2015, 54 banks had failed, a significant number of additional banks failed in 2016, and the NBU had closed 88 banks by 2017. The insolvent banks were transferred to the management of the Deposit Guarantee Fund (DGF), which paid depositors up to a ceiling of Hrv 200,000 in any single bank. Under the DGF legislation passed in 2012, shareholders and related party depositors were not compensated.

1.13 After the DPL series closed, in late 2016 the government nationalized the largest private commercial bank in the country, PrivatBank, when it could not meet the NBU

requirement that banks have a capital adequacy ratio (CAR) of at least 5 percent of risk-weighted assets. PrivatBank was found to have engaged in massive related party lending, with most of its assets consisting of loans to companies owned by its largest shareholder. PrivatBank was nationalized rather than closed because of its systemic importance to the financial system. Recapitalizing PrivatBank necessitated the injection of \$6.5 billion, more than 5 percent of Ukraine's 2017 GDP. In discussion, Ukrainian counterparts indicated that this step should have been taken earlier.

1.14 However, Ukrainian interlocutors indicated that this step was not well understood within the country. PrivatBank had been an innovator in providing financial services to many depositors and was viewed widely by the public as the most effective commercial bank within the country. As a result, although the nationalization was fully justified, a number of Ukrainian counterparts indicated that it was a politically unpopular move. Its former owner, one of the most powerful industrialists in the country, immediately sued to annul the nationalization. Subsequent court decisions supported the former owner in his lawsuit, although substantial uncertainty surrounds the outcome of the ongoing case as of November 2019.

1.15 During 2014–16, international financial institutions responded rapidly to the financial sector shocks that threatened the banking system's stability. The IMF announced a \$17.5 billion four-year extended fund facility in 2014; the World Bank approved two development policy operations in 2014 and 2015 for \$500 million each (the subject of this Project Performance Assessment Report); the European Bank for Reconstruction and Development (EBRD) increased investments by more \$1 billion; and the governments of Germany, Japan, Norway, and the United States provided additional support. The World Bank also engaged in other lending to support financial sector reform and governance in Ukraine (box 1.2).

Box 1.2. World Bank Support to Governance and Financial Sector Reform in Ukraine: 2014–18

In 2014–16, World Bank support consisted of two series of budget support operations. First, two development policy loans were approved in 2014 and 2015 for \$750 million (IBRD-8392) and \$500 million (IBRD-8511), aimed at promoting good governance in the public sector, strengthening the regulatory framework, reducing the cost of doing business, and reforming utility subsidies. Second, the financial sector development policy loan series of two \$500 million loans was approved in 2014 (IBRD-84220) and 2015 (IBRD-85370) (the subject of this Project Performance Assessment Report). In 2016, a \$500 million guarantee (IBRD G-2440) was provided to support the security of the natural gas supply by enhancing Naftogaz’s ability to buy gas supplies through cost-effective financing. In late 2018, the World Bank provided Ukraine with a policy-based guarantee (IBRD G-2800) of \$750 million for “economic growth and fiscally sustainable services.” One of the program development objectives was to “strengthen factor markets and institutions,” which contained prior actions directed at improving the governance of state-owned banks and facilitating the resolution of nonperforming loans. An additional loan of \$150 million (IBRD-8727) was supplied to UkrEximBank, a state-owned bank, to improve access to longer-term financing for export-oriented small and medium enterprises.

1.16 Preventing the financial crisis from leading to a total collapse of the banking system required massive injections of liquidity. Altogether, the cost of supporting the banking system during 2009–17 amounted to about 15 percent of GDP.

2. Relevance of the Objectives and Design

2.1 The two financial sector operations of the World Bank (DPL1 and DPL2) were part of the World Bank’s broad support operation to assist Ukraine during the 2014–16 crisis. In turn, World Bank support was part of the coordinated international assistance efforts in which the EBRD, the European Commission, the IMF, and the governments of Germany, Japan, Norway, and the United States collaborated to provide Ukraine with immediate assistance to stem the hemorrhaging of the banking system caused by large withdrawals of both domestic and foreign currency–denominated deposits.

2.2 Donor assistance was also designed to support longer-term fundamental reforms, particularly those related to the NBU and the DGF that were necessary to return Ukraine to sustainable growth and to buttress the financial sector against future vulnerabilities by tackling issues that had not been addressed in the 2008–09 crisis. In doing so, World Bank support meshed with that of the EU, the IMF, and bilateral aid institutions. Although the number of failed banks increased over this period, the actions of the NBU and the DGF in closing banks that were inadequately capitalized strengthened the long-term viability of the privately owned portion of Ukraine’s financial system.

Objectives

2.3 The project development objectives (PDOs) of both DPL1 and DPL2 were the same, although some prior actions were revised under DPL2. The PDOs of both DPLs were as follows:

1. To resolve insolvent banks by strengthening the financial, operational, and regulatory capacity of the DGF;
2. To improve the solvency of the banking system through the implementation of bank recapitalization and restructuring plans and timely enforcement action; and
3. To improve the resiliency and efficiency of the banking system by strengthening the legal and institutional framework.

Policy Areas

2.4 The DPL program was designed around three policy pillars and their respective prior actions that were selected to directly support the achievement of the three PDOs.

2.5 Pillar 1 of DPL1 was designed to strengthen the financial, operational, and regulatory capacity of the DGF. A critical priority was to ensure that through the availability of backup funding, the DGF could meet payout obligations to depositors arising from the increasing number of failed banks. This was a key component of measures that were necessary to ensure that the confidence in the banking system would be restored.

2.6 Confidence in the financial system continued to be battered as the number of failing banks increased throughout 2014–16 because geopolitical events deepened the fragility of the banking system. Failed banks were transferred to the DGF for resolution and payouts to depositors. Therefore, a perception that the DGF had adequate funding was essential to ensure that a financial panic did not occur.

2.7 Additionally, this pillar was designed to provide the DGF with the organizational authority to handle the resolution of the large number of banks that were failing and the capacity to deal with them, and to improve coordination with the NBU in regulating the banking system.

2.8 Pillar 2 was directed at ensuring that banks had sufficient capital to remain solvent, based on independent diagnostic assessments, and at implementing remedial actions to address weaknesses. This would be done through the NBU using its supervisory powers to ensure that banks found to be undercapitalized enter into a recapitalization process within a fixed time frame or be passed to the DGF for resolution.

The exceptions were large institutions considered systemically important, which the government would recapitalize based on arrangements that ensured that public funds were not misused.

2.9 Pillar 3 was directed at improving the banking sector's regulatory and institutional framework to make it more resilient against future shocks. Essentially, this pillar was also designed to address the long-term systemic institutional weaknesses that the reform efforts arising out of the previous crisis had not addressed. It aimed at identifying problem banks promptly, improving corporate governance in the sector, enhancing supervision, promoting banking sector consolidation, and implementing divestiture of those banks that the state recapitalized.

2.10 During the preparation of DPL2, prior actions in pillar 3 were strengthened by requiring enhancement of the NBU's powers to identify related party lending, the establishment of a high-level financial stability council, and that the NBU issue regulatory and supervisory requirements for systemically important banks.

Relevance of the Objectives

2.11 The World Bank Group's Country Partnership Strategy (CPS) for fiscal years 2012–16 centered around two pillars and three results areas. The CPS pillars were (i) building relations with citizens and (ii) building relations with business. The pillars had 20 outcomes, one of which was "increased stability of the financial system." From this perspective, the DPL series was consistent with the CPS for Ukraine for 2012–16. The CPS noted that Ukraine had failed to address the serious structural weaknesses that remained after the 2009 economic and financial crisis (World Bank 2012, iv). It indicated that the risks related to poor implementation of past reforms and weak governance made the risks associated with DPL lending for direct budget support unacceptably high. Although separate analytical work identified systemic problems, the Country Assistance Strategy did not focus in detail on the fragility of many of the commercial banks (which was a legacy from the previous crisis) and continuing unsound lending practices. It also did not flag the dangers inherent in the amount of domestic debt denominated in foreign currency, thus making financial sector stability dependent on maintaining a stable exchange rate in an environment in which fiscal probity was at a premium.²

2.12 A perfect storm occurred in 2014 as the geopolitical situation descended into deep crisis that arose from political upheaval, the annexation of Crimea, and the armed separatist movement in the eastern part of the country that was in open conflict with Ukraine's armed forces. The exchange rate depreciated by 47 percent; inflation accelerated to 24 percent; the public sector fiscal deficit exceeded 10 percent of GDP, at

least partly because Naftogaz experienced large losses; and public debt, including guarantees, spiked to 70 percent of GDP. The structural weaknesses in the financial sector were exposed suddenly and brutally, resulting in large deposit outflows and increased NPLs, which led to large numbers of bank failures.

2.13 World Bank support under the two DPLs was therefore **relevant** in supporting Ukraine in response to these shocks because the outflow of deposits threatened a bank panic that could have led to a financial meltdown. By focusing on financial sector reform, the DPLs were also an important component of the multidonor support program, which included the EBRD, the European Commission, the IMF, the World Bank, and the governments of Germany, Japan, Norway, and the United States, which aimed to support Ukraine through the geopolitical crisis and stabilize the banking system.

2.14 Relevance of objectives is rated **high**.

Design

2.15 The design of DPL1 took place as the pace of the crisis deepened. The rate of bank failures accelerated through 2014, and an urgent question arose regarding whether the DGF would have sufficient liquidity to meet the demands the bank failures placed on it. The pace of withdrawals of deposits continued unabated, and the risk of depositor panic, which could have led to the collapse of the financial system, was at the forefront of concerns of the government and donors alike.

Donors, including the World Bank, prepared assistance at an accelerated pace to assist Ukraine in weathering the crisis and in particular to stabilize the banking system. The design of DPL1 and DPL2 supported and complemented the EU and IMF programs. The reform program under DPL1 and DPL2 consisted of a series of measures to help prevent a complete loss of confidence that could have resulted in a banking panic. The design of the program aimed to achieve the three development objectives. The prior actions in the two programs were interlinked and mutually supportive, so they are discussed by issue rather than separately for each DPL.

Components

2.16 The main measures and the prior actions in DPL1 and DPL2 were as follows:

Pillar 1 was designed to strengthen the financial, operational, and regulatory capacity of the DGF.

- Prior action 1 of both DPL1 and DPL 2 required the strengthening of the DGF's capacity to meet financial demands arising from payouts to depositors of failed

banks and to deal with resolving the assets of these banks through a backup funding provision from the government. This was critical to ensuring that deposit withdrawals did not turn into a full-fledged run on the banks.

- Prior action 2 of DPL1 increased the range of bank resolution instruments available to the DGF and streamlined the processes. These instruments assisted the DGF in dealing with insolvent banks.
- Prior action 2 under DPL2 required the authorities to speed up reimbursement of insured depositors. This related to prior action 1 of both DPLs and contributed to increasing confidence that deposit insurance would be paid.
- Prior action 3 under DPL1 required a revised operational budget for the DGF that strengthened its capacity to deal with higher technical demands on staff and the increased workload. Under prior action 3 of DPL2, the authorities would increase the efficiency of the DGF's asset management function. These prior actions contributed to improving the DGF's institutional capacity.
- Prior action 4 required strengthening cooperation between the NBU and the DGF with a memorandum of understanding signed between the two institutions to enhance information sharing on problem banks. This prior action improved the ability of the two institutions to share information that would identify problem banks earlier in the supervisory process.

Pillar 2 was directed at ensuring that banks had sufficient capital to remain solvent, based on independent diagnostic assessments, and at implementing remedial actions to address weaknesses.

- Prior action 5 of DPL1 addressed the urgent need to recapitalize banks. It was designed to improve banks' solvency through the establishment of key principles for restructuring and recapitalization and the adoption of corrective action plans for undercapitalized banks. This was augmented under prior action 6 of DPL2, which established a legal mechanism for state participation in bank recapitalization if such banks were systemically important. This prior action contributed to addressing problems that had not been addressed in the 2008 crisis.
- Prior action 6 of DPL1 required the NBU to undertake independent diagnostic studies of the 35 largest banks, and the 15 largest banks to sign contracts with qualified auditors. This was augmented by prior action 4 of DPL2, which required the NBU to certify the recapitalization of 13 of the 35 largest banks in the amounts that had been identified as necessary through the diagnostic studies. Five of the banks were unable to meet the capital requirements and were transferred to the DGF

for resolution. Furthermore, under prior action 5 of DPL2, the NBU was to initiate updated diagnostic studies. This prior action contributed to improving regulatory oversight by both the NBU and the DGF and the cooperation between the two institutions.

Pillar 3 was directed at improving the banking sector’s regulatory and institutional framework to make it more resilient against future shocks.

- The speed with which developments were occurring and pressures were building on the financial system was recognized by requirements that information on banks be current and constantly updated. This was embodied in prior action 7 of DPL1, which mandated the introduction of additional criteria for timely identification of problem banks. This was further strengthened by prior action 9 of DPL2 through the establishment of a high-level financial stability committee to oversee the stability of the financial system. This prior action contributed further to regulatory oversight. The establishment of this committee was a positive step and contributed to driving the outcomes of the financial sector reforms.
- Prior action 8 of DPL1 was directed at further strengthening the banking system’s legal and institutional framework through a requirement that authorities strengthen commercial banks’ corporate governance framework. The authorities augmented this under prior action 7 of DPL2 by also strengthening the framework for identifying and reporting related party lending. This prior action gave the authorities power to improve banks’ corporate governance. With regard to state-owned banks, the World Bank provided technical assistance and inputs to legislation governing their operation.
- Prior action 9 of DPL1 was directed at disclosing the ultimate beneficial owners of commercial banks through obtaining accurate ownership information regarding the 35 largest banks. This information was published on the NBU website. In DPL2, this measure was supplemented by prior action 8, in which the NBU initiated a review of related party lending.
- Prior action 10 of DPL2 required the NBU to issue regulatory and supervisory requirements for systemically important banks. This was important in identifying these banks and ensuring that they were adequately capitalized and managed.

2.17 A trigger in DPL1 for DPL2 required a time-bound strategy for the divestiture of state-owned banks. This was dropped in the program document for DPL2 because “market conditions have not been appropriate to sell banks” (World Bank 2015, 30). However, the program document notes that the World Bank continued to provide

technical assistance on developing a strategy for state-owned banks that includes divestiture and improving their governance and oversight.

2.18 A further issue that arose after the DPL series had ended was that the largely unregulated insurance sector grew rapidly to the extent that observers in Ukraine expressed concern that it could be a source of future systemic weakness. The “Split Law,” passed in the second half of 2019, brings the sector under the regulatory authority of the NBU. Effective implementation will be key in determining its effectiveness.

Relevance of the Design

2.19 The causal chain inherent in DPL1 and DPL2 was clear, relevant and, in some regards, logical and consistent with best practice responses to systemic crises. Financial shocks such as those that Ukraine faced in 2014–15 are usually characterized by a fall in aggregated demand (magnified in Ukraine by the loss of substantial physical assets in the eastern part of the country) and a collapse of confidence that led to widespread withdrawal of deposits. This occurred in Ukraine in 2014–15. The highest priority for the monetary authority was to inject sufficient liquidity into the system to convince depositors that their assets were safe. This required the NBU to provide liquidity to sound private sector commercial banks and the government to commit to ensuring that the DGF had resources to reimburse depositors in failed banks up to the statutory limit.

2.20 The EU, the IMF, the World Bank, and bilateral donors responded quickly to provide liquidity. In addition, the conditionality of the DPL series sought through its prior actions to strengthen systemic weaknesses by improving the legislative framework underlying the financial system and to strengthen its central institutions, namely the DGF and the NBU. Furthermore, measures were introduced to ensure that equity holders and others involved in related party lending were not bailed out in the process and, unlike in the 2008 crisis, former shareholders did not have influence over lending decisions. In addition, many of the measures that had not been taken in the previous crisis were implemented in 2014–16, including greatly strengthened supervision processes, a bank resolution framework, stress testing of banks, and strict recapitalization rules.

2.21 Two weak links in the causal chain were associated with the DPL series. The first was the failure to appreciate fully the depth of issues related to state-owned banks, particularly those that were systemically important (see appendix D for a description of state-owned banks). The program design did not analyze fully the implications of the section of the criminal code that prevented writing down and selling state-owned bank assets. Consequently, even as late as mid-2019, the NPLs of the state-owned banks still constitute more than 50 percent of their portfolios with the likelihood that the actual

realizable value of each portfolio is only a fraction of the face amount. Although a significant portion of the NPLs have been provisioned, the lack of resolution of this issue delays the full recovery of this portion of the financial system and severely limits privatization possibilities.

2.22 The second weak link was the failure to appreciate that a corrupt judicial system at both the court and prosecutorial levels was a binding constraint to sustainably reforming the financial system. Neither is impartial, so that the contracting framework is not inviolable to outside pressure. Numerous interlocutors in Ukraine indicated that corruption taints the judicial framework, which undermines arm's-length contracting and makes doing business risky. Although extensive judicial sector reform was beyond the scope of the program, additional acknowledgment of this constraint and its implications for reform would have improved program design. Donors attempted to address this by requiring passage of a list of basic legislation (appendix E), but as of October 2019, only two components of the necessary legislation have become law. Furthermore, passing legislation in an environment in which the court system is corrupt can be of questionable usefulness.

2.23 The outcome indicators for the DPL series were relevant and measurable. DPL1 and DPL2 had five and six outcome indicators, respectively, the achievements of which are discussed in section 3, Implementation.

2.24 There were several important omissions in the set of indicators. These included:

- A target for reducing outstanding NPLs in the system, particularly for the state-owned banks; and
- Any measure of the financial solvency of the DGF, which had to undertake significant borrowing from the government to meet its payout obligations. As of end-2018, the DGF's audited accounts showed that it had a negative equity position of Hrv 64.6 billion (the next paragraph discusses this issue).

2.25 The program design did not address a number of issues, mainly the following:

- Dealing with the long-term solvency of the DGF. To some extent, this was understandable because the immediate priority was to ensure that it was able to reimburse insured depositors in failed banks. Furthermore, bank failures were far more numerous than had been initially anticipated, especially in DPL1. Nevertheless, as the extent of the collapse of approximately half of the commercial banks became apparent while DPL2 was being prepared, some provision for returning the DGF to solvency might have been considered. Although it was possible to maintain that the government would not allow the

DGF to fail, making its solvency an explicit policy goal would have contributed to bolstering confidence in the financial system.

- The need for a procedure to address the insolvency of banks' debtors as NPLs mounted rapidly. Previously, in 2013, the World Bank had supported a bankruptcy law with technical assistance, but it contained weaknesses that were revealed in the 2014 crisis, in particular that the court system heavily favored borrowers in its proceedings. A new bankruptcy law was initiated in 2017, which the legislature passed. There were delays in the law being signed by the president, in violation of the constitution. However, it was signed before the presidential elections and came into force in October 2019.

2.26 Although there were weak links in the causal chain and shortcomings in dealing with state-owned banks, the necessity of reacting expeditiously to the financial meltdown in 2014 and the measures in the DPL series to strengthen the institutions supervising the financial system leads to a rating of **substantial** for relevance of design.

3. Implementation

3.1 DPL1 and DPL2 were implemented between August 2014 and June 2016. The World Bank's Board of Executive Directors approved the first DPL on August 8, 2014, and it closed on November 30, 2014. The second DPL was approved on September 15, 2015 and closed on June 30, 2016. Extended technical assistance from the World Bank and other development partners, particularly the IMF, also supported the DPL series.

3.2 DPL1's original policy areas were not revised in DPL2, but some prior actions were strengthened. This requirement arose as the financial crisis deepened and was needed to ensure that the DGF had sufficient resources to meet its obligations to depositors of failed banks and that reimbursements made to insured depositors were timely.

3.3 Although the macroeconomic situation regarding the budget and balance of payments deficits improved, external shocks led to further pressure on the financial system. Implementation under both DPL1 and DPL2 was adversely affected by the deterioration in the geopolitical situation, particularly the separatist war in eastern Ukraine that resulted in a sharp further depreciation in the exchange rate in 2015 (figure 1). This had the dual effect of further accelerating the loss of deposits from the banking system, particularly those denominated in foreign currency, and increasing domestic currency liabilities of borrowers that had foreign currency loans, both of which put additional pressure on the DGF and the NBU. The DGF's financial obligations and the need to develop further bank resolution plans both increased because of the

accelerating rate of bank failures. The NBU had to ensure adequate liquidity in the system and approve additional bank recapitalization plans for those that were systemically important. At appraisal, the first DPL did not anticipate the very high number of bank failures. At appraisal of the second DPL, the number of failed banks had increased significantly and was close to the actual outcome.

3.4 Implementation was assisted by an important reform that emerged from the 2008 crisis, and it contributed to the effectiveness of the DPL series. The DGF had been transformed from a pure deposit insurance entity into a bank resolution institution. Its ability to undertake bank resolution was further strengthened in 2012 through passage of a new law governing the DGF's operation. The law gave the DGF additional powers to intervene in failing banks and stipulated that shareholders, managers, and related parties of failed banks could not be reimbursed for either equity or losses arising from outstanding deposits that they held in these institutions. It also provided an improved means of funding the DGF by requiring commercial banks to pay an insurance premium for the deposit guarantees. In addition, the limit on deposit insurance coverage was raised.

3.5 Substantial improvements in the technical capacity of the DGF and the NBU, including substantial technical assistance from the World Bank, also helped implementation. An additional difference in how the 2014–16 crisis was addressed compared with the 2008–10 crisis was that the capacity of Ukraine's supervisory institutions was improved both by training and by the return of some highly qualified Ukrainians who had been working in major financial centers in Europe and the United States.

3.6 The DGF's and NBU's improved performance enhanced implementation, and this was complemented by greatly improved communication among all parties involved. A prior action under DPL1 required the signing of a memorandum of understanding between the DGF and the NBU to improve information sharing about problem banks. According to all parties interviewed in Ukraine, cooperation between the two institutions was excellent.

3.7 There was also close cooperation among donors. Many donor representatives interviewed indicated that at the outset of the crisis, coordination among them had been quite loose, but this had changed radically by 2015, and both multilateral and bilateral institutions worked together closely to coordinate their actions and present a united position regarding reforms in dealing with Ukraine authorities.

Environmental and Social Effects

3.8 **Environmental effects.** This financial sector DPL series did not trigger any World Bank environmental safeguard policies.

3.9 **Social effects.** Because deposits in the privately owned commercial banks were insured up to Hrv 200,000 (\$13,000 at the outset of the crisis and \$7,700 by the end of 2016) and all deposits at the state-owned banks were fully insured, the deposit insurance program coverage exceeded 98 percent of all deposits in the Ukraine banking system. This covered most households in the country and in particular a significant number of the poorer sections of the population.³ Because commercial banks dominated the financial system, the direct financial social impact of the crisis was limited, though the contraction of the economy had adverse effects on the incidence of poverty.

Financial Management

3.10 There were no financial management issues, although program document 1 flags fiduciary risks as substantial. However, no financial management issues arose during implementation or at the completion of the DPL series.

4. Achievement of the Objectives

4.1 This section analyzes the outcomes of the DPL series of two loans in 2014 and 2015 and their sustainability after the series closure. Rapidly unfolding events influenced outcomes in several policy areas. Furthermore, access to a long-term finance loan and a policy-based guarantee for “economic growth and fiscally sustainable services” also influenced outcomes. Moreover, other development partners—including the EBRD, the EU, and the IMF—supported reforms in Ukraine both during and after the closing of the series. This Project Performance Assessment Report assesses this financial sector DPL series’ contribution to the achievement of the PDOs, but given how closely the donors cooperated, completely disentangling the effects is not always possible. Furthermore, several events after closing had substantial impact on the series’ longer-term outcomes.

Objective 1: Strengthening the Operational, Financial, and Regulatory Capacity of the DGF for the Resolution of Insolvent Banks

4.2 To achieve this objective, the series shored up the DGF’s financial capacity by providing it with long-term funding from the government, expanding the number of bank resolution instruments, increasing the DGF’s staffing and budget, and improving cooperation with the NBU to share information on problem banks.

Strengthening the DGF's Financial Capacity

4.3 The intent of prior action 1 under both DPLs was to strengthen the DGF's financial capacity. The mechanism for doing so was enacting a Law of Amendments to the State Budget Law of Ukraine, which would provide it with a backup funding mechanism from the state to ensure that it could meet payout requirements for insured depositors, thereby forestalling financial panic. It could be triggered whenever the ratio of DGF reserves fell below 2.5 percent. The facility was used in each year during 2014–16 as follows:

- In 2014, when the DGF received Hrv 10.1 billion (\$630 million);
- In 2015, when it received Hrv 41.5 billion (\$1.729 billion); and
- In 2016, when it received Hrv 7.9 billion (\$329 million).

4.4 The financing mechanism used was government-issued bonds, which the NBU subsequently monetized. The outcome indicator for this component of pillar 1 was that the DGF's funding ratio remain above 2.5 percent and that 100 percent of depositors in insolvent banks would be reimbursed. Both targets were achieved by 2016; the state funding and monetization from the NBU maintained the funding ratio, resulting in 100 percent of depositors being reimbursed.

4.5 The total amount the DGF borrowed from the NBU and the government was Hrv 84.4 billion, including interest owed (the interest rate on outstanding borrowings is 12.5 percent). As of mid-2019, the DGF's liabilities exceed its assets by more than Hrv 60 billion. However, the government is committed to ensuring its eventual return to solvency.

Strengthening the DGF's Regulatory and Institutional Capacity to Address Insolvent Banks

4.6 Prior action 2 required expanding the instruments at the DGF's disposal for bank resolution. This necessitated the enactment of the law governing the range of bank resolution instruments to give the DGF additional tools to address insolvent banks. These tools consisted of the following:

- Enabling the DGF to use a bridge bank as a resolution instrument by acquiring the assets and insured deposits from multiple insolvent banks;⁴
- Enabling the DGF to consolidate bad assets from multiple banks as insolvent banks were transferred to it; and
- Enabling the state to participate in the resolution of insolvent banks when they were systemically important.

4.7 In addition, the DGF's institutional and operational framework required strengthening to accommodate the greatly increased workload arising from the failure of nearly half of all banks in Ukraine. This required hiring experienced staff and consultants. The salaries of the latter were mainly supported by donors.

4.8 Prior action 3 provided the DGF with an increase in budget and additional staff to deal with the multiple bank failures. This was to be achieved by hiring new staff,⁵ upgrading the capacity of existing staff, and cooperating closely with the NBU in supervision processes. Historically, coordination between the two institutions had not been adequate. The DGF required current information about problem banks to deal effectively with bank resolution and anticipate possible failures. The NBU would supply this information through prior action 4, which involved improved coordination between NBU and the DGF under a memorandum of understanding on the timely exchange of information. This led to DGF staff participating in joint meetings between the DGF and the NBU on corrective actions for problem banks. In addition, the DGF acquired increased supervisory powers in its own right and additional powers for the resolution of insolvent banks.

4.9 Three prior actions were added to pillar 1 under DPL2, namely: (i) the NBU would certify the adequacy of bank capitalization, and those banks that could not meet the requirements would be transferred to the DGF; (ii) the NBU would update diagnostic analysis of the capitalization of the 20 largest banks; and (iii) a legal mechanism for state participation in the recapitalization of banks would be initiated.

4.10 These prior actions required enactment of two laws that minimized the negative effects on the banking system's stability and strengthened the corporate governance requirements on commercial banks. The third prior action under DPL2 required the NBU to disclose the beneficial owners of commercial banks.

4.11 The original outcome indicator for this component of pillar 1 was the implementation of 20 bank resolution plans by the DGF. However, as the situation deteriorated, DPL 2 augmented this indicator to 54 resolution plans. Even this number underestimated the extent of the banks' financial insolvency, and the actual number achieved was 80 resolution plans by the end of 2016.

4.12 Overall, the prior actions in DPL1 and DPL2 achieved this objective. The policies implemented contributed significantly to the mitigation of the impact of the crisis on the banking system. Modifications were made under DPL2 that addressed the deteriorating situation and bolstered the DGF's and the NBU's support for the financial sector. Although these measures were coordinated with other donors, the World Bank lead

regarding technical analysis and support in the financial sector appeared to have been decisive.

4.13 The DPL program's efficacy in achieving this first objective is **substantial**.

Objective 2: Improving the Solvency of the Banking System through Implementation of Bank Recapitalization and Restructuring Plans and Timely Enforcement

4.14 This pillar and its prior actions supported the achievement of PDO2. It focused on the NBU's role in approving bank recapitalization plans and the process of identifying and restructuring at-risk banks. The key principles of bank recapitalization and restructuring were established under prior action 5 of DPL1, along with criteria for state participation in the recapitalization of banks.

4.15 The NBU's role was further cemented through prior action 6 of DPL1, which required the NBU to initiate time-bound diagnostic studies of the condition of the 35 largest banks' balance sheets. These studies were to be based on the 2014 European Central Bank methodology for asset quality reviews. Under DPL2, prior action 4 required the NBU to certify the recapitalization of 13 of the 35 largest banks to the amounts identified in these studies. Any banks that could not meet the recapitalization requirements were to be transferred to the DGF for resolution. This process was further strengthened through prior action 6 of DPL2, in which a legal foundation was established for state participation in this process in circumstances in which the resolution through the DGF would compromise its financial stability.

4.16 In addition, because of the deteriorating economic situation and continued pressure on the commercial banks, prior action 5 of DPL2 required the NBU to update the diagnostic studies for the 20 largest banks. Undercapitalized banks identified would be required to present credible recapitalization plans that would be completed by the end of 2018—any that could not do so would also be transferred to the DGF for resolution.

4.17 The outcome indicator for objective 2 under DPL1 was that the CAR for the consolidated banking system exceeds 10 percent. This was modified under DPL2 to requiring that the CAR for the 20 largest banks exceed 5 percent, which was achieved for 17 of the largest banks; 2 others were declared insolvent and passed to the DGF for resolution, and one (PrivatBank) was nationalized. There was no justification provided in program document 2 for the decline in the required CAR from 10 percent to 5 percent. An additional outcome indicator related to this was added in DPL2, which was that bank recapitalization plans be approved for the 20 largest banks or they would be

passed to the DGF for resolution, based on the updated diagnostic studies of financial soundness.

4.18 Both the NBU and the DGF mostly undertook their roles in a timely fashion to enforce the resolution of undercapitalized banks or to ensure that they injected additional equity. However, interviews with public and private sector counterparts in Ukraine suggested that the nationalization of PrivatBank could have occurred earlier.

4.19 Overall, the prior actions embodied in the second policy pillar substantially supported the achievement of PDO2 by strengthening the NBU's role in identifying problem banks in a timely fashion, developing recapitalization plans, and undertaking ongoing diagnostic studies under circumstances in which pressure on the financial system was raising systemic risks. These measures, supported by the World Bank through the DPL series, bolstered confidence and reduced risks. As a result, substantial progress was made on returning the remaining banks to financial soundness. By end 2018, NPLs of private commercial banks had fallen to 10 percent, all of which had been fully provisioned.

4.20 The achievement of the DPL program's second objective is **substantial**.

Objective 3: Strengthening the Legal and Institutional Frameworks to Improve the Resiliency and Efficiency of the Banking System

4.21 The prior actions under pillar 3 supported PDO3 by addressing longer-term issues that had not been resolved after the 2008–10 crisis. They were aimed at strengthening the process of bank supervision to identify any incipient problems at an early stage.

4.22 Additional criteria for the early identification of problem banks were introduced under prior action 7 of DPL1. This was to be achieved through amendments to the law on banks that added quantitative criteria related to liquidity, asset quality, and capital adequacy. This provided a legal foundation for the CARs that were stipulated under objective 2. Furthermore, prior actions 8 and 9 of DPL1 were directed at strengthening corporate governance of the commercial banks and identifying and disclosing beneficial ownership of the 35 largest banks. It included amending the corporate governance requirements to strengthen the rights and powers of bank shareholders, the supervisory boards, and audit requirements. In addition, it augmented the necessary standards for supervisory boards and bank managers.

4.23 The powers of the NBU to identify related party lending was increased under prior action 7 of DPL2, along with penalties that could be imposed on the related parties, which included criminal penalties if the lending or borrowing relationship led to the

insolvency of the bank in question. This issue was addressed further under prior action 8 of DPL2, which required the NBU to initiate reviews of related party lending in the 10 largest private banks. If related party lending exceeded the norms identified, the banks would be required to present unwinding plans to an NBU committee that included IMF and World Bank observers.

4.24 Prior action 9 of DPL2 addressed governance of the financial sector as a whole, providing for the establishment of a high-level financial stability committee that would meet regularly to discuss potential risks to the financial system.

4.25 Under prior action 10 of DPL2, the NBU issued regulatory and supervisory requirements for systemically important banks, including state-owned banks that complied with Basel III requirements on capital buffers. The NBU also mandated that systemic banks periodically prepare recovery plans that are submitted to the NBU.

4.26 The outcome indicators for objective 3 purported to measure the consolidation of the banking system, the extent of related party lending, and how many recovery plans were adopted. Under DPL1, the target for banking sector consolidation was 150 remaining banks compared with a baseline of 181, which in the event underestimated the extent of bank insolvency (World Bank 2014, 34). Under DPL2, this number was reduced to 100 remaining banks, and the actual number of solvent banks in 2016 was 96. DPL1 also targeted the adoption of recovery plans by all domestically systemically important banks. Under DPL2, the outcome indicator was the agreement on unwinding related party lending by the 10 largest banks, which was 100 percent achieved by 2016.

4.27 Notably missing in the indicators was any measure of the extent to which lending to related parties that resulted in bank failure was prosecuted despite the provisions of prior action 7. Interlocutors in Ukraine indicated that there has been no prosecution under this regulation.

4.28 Measures implemented under the DPL series primarily addressed issues related to private banks. Before the nationalization of PrivatBank in December 2016 after the closing of DPL2, state-owned banks constituted less than a quarter of the banking system, and the most significant risks in the system were private banks. No effective progress had been made with the state-owned banks besides having them provide for the majority of their NPLs that remained on their balance sheets at 100 percent of their nominal value. The effect of this was to heighten the difficulty of privatizing any of the state-owned banks because of uncertainty regarding how to address the NPL issue.

4.29 The DPL program's efficacy in achieving the third objective is **modest**.

5. Ratings

Outcomes

5.1 The overall outcome is rated **satisfactory**. World Bank support was provided rapidly under difficult circumstances, and assistance was given in critical areas in the private sector component of the financial system so that confidence in private sector banks was restored. Because the government guaranteed the state-owned banks' deposits, issues related to confidence in their deposits did not arise.

5.2 The rating is based on substantial relevance of objectives, substantial relevance of program design, substantial achievement of the first and second objectives, and modest achievement of the third objective, with an overall efficacy rating of **satisfactory**.

5.3 A notable shortcoming in design was the failure to account for issues surrounding the state-owned banks and particularly their NPLs. As a result, the governance structure of state-owned banks—including the role of politicians in appointing supervisory boards—remains largely intact, though efforts to improve these are currently under way. Interlocutors in Ukraine report that as of June 2019, the likely outcome in this area remains unclear.

5.4 The achievement of the first objective strengthened the DGF's financial capacity to reimburse insured depositors in failed banks and developed a longer-term funding mechanism, in which the state provided a backup funding mechanism to ensure that resources were available, thereby forestalling financial panic under circumstances that saw the large-scale withdrawal of deposits from the banks. In addition, the DGF's regulatory and institutional capacity to deal with failed banks was also strengthened by providing it with increased budget and staff. It also strengthened the DGF's ability to implement bank resolution plans and improved cooperation between the NBU and the DGF.

5.5 The achievement of the second objective focused on recapitalizing or restructuring commercial banks that were capitalized adequately or could present credible plans to achieve the appropriate level of capitalization. The NBU's supervisory capacity and technical expertise were enhanced significantly.

5.6 The third objective improved the legal and institutional framework for the banking system by providing a legal foundation for the NBU to ensure the capital adequacy of banks and tools to deal with related party lending, but there were shortcomings.

5.7 Circumstances have also changed. In 2008, the share of state-owned banks in total banking assets was 11 percent. By 2013, it had grown to more than 20 percent. By the end of 2016, after the nationalization of PrivatBank, domestic state-owned banks controlled more than 50 percent of total banking assets. Furthermore, the governance of the state-owned financial sector and the potential threat it posed to the economy was of significant concern.

Risk to Development Outcome

5.8 The risk to development outcomes in the financial sector is **high** because of a number of factors. Fundamental financial sector reform in Ukraine involves complexities, and therefore this section goes beyond assessing the immediate risks of not sustaining the objectives of the DPL series to examining longer-term prospects for Ukraine's financial sector.

5.9 The fundamental question in assessing the long-term risk to the success of the DPL series is whether the interventions encapsulated in DPL1 and DPL2 have strengthened the financial system so that it can withstand future endogenous or exogenous shocks.

5.10 On the positive side, macroeconomic indicators have improved significantly. External and domestic imbalances have improved dramatically, and Ukraine authorities continue to pursue prudent fiscal and monetary policies. There has also been a marked upgrading in the function of the regulatory system for the private commercial banking sector. One of the most significant achievements of DPL1 and DPL2 has been the strengthening of the regulatory and resolution capacity of both the NBU and the DGF for private sector banks. This contrasts with the aftermath of the 2008–10 crisis, when the political class's appetite for regulatory reform diminished markedly once the immediate pressures of the crisis receded.

5.11 However, a number of factors pose high risks to sustainability in the financial sector. These are, in rough order of priority:

- **The large share of state-owned banks in the financial system.** In 2008, the share of state-owned banks in total banking assets was 11 percent. By the end of 2013, it had grown to more than 20 percent. By the end of 2016, domestic state-owned banks controlled more than 50 percent of total banking assets, which far exceeds the state's share of the total GDP. As of mid-2019, there has been little change in this share, which exposes the operation of the state-owned banks to risks of political capture and influence from vested interests.

- **Inadequate legislation governing the financial sector.** The failure to pass or implement critical legislation governing the financial sector continues to hamper the financial system's full recovery, although some laws have been passed in the second half of 2019. Appendix E contains a list of laws requested by donors that have yet to be passed. In addition, by mid-2019, the president had not signed the insolvency law that the legislature had passed, which violated constitutional requirements regarding legislation sent for signing. However, the law was finally signed before the national elections and became effective in October 2019.
- **The essentially unregulated insurance sector in Ukraine.** This sector is growing rapidly and appears to be a target for illicit activity by special interests. Donors have recommended giving the NBU oversight authority over the sector and have called for passing legislation to this effect (the "Split Law"), which was passed in the second half of 2019. It will bring the insurance sector under the regulatory authority of the NBU. Implementation will be key in determining the impact of the law.
- **Limited capacity within the regulatory systems.** DPL1, DPL2, and strong follow-up support in the postcrisis period have strengthened the regulatory structure to the point that those interviewed in Ukraine indicated that the NBU is regarded as an exemplar in the region. However, the newly acquired expertise might not be sustainable. The upgrading of the NBU and the DGF was strongly supported by the return of Ukrainian expatriates from some of the world's main financial centers. Part of their motivation for returning appears to have been inspired by a sense of patriotism after the Euromaidan revolution of 2014, but the Ukraine public sector's very low salaries would have been a substantial financial sacrifice for those returning. As a result, donors have been paying the salaries of senior consultants who returned from the West. Whether this is sustainable is uncertain. Furthermore, research by the World Bank and others suggests that the ability of technocrats to formulate and implement reform policies without being unduly influenced by vested interests is an important element in the arm's-length development and sustainability of reforms (World Bank 1993). Whether these conditions can be sustained in Ukraine is an open question.
- **The fragile financial state of the DGF.** Currently, the DGF is insolvent with a negative net equity position of Hrv 64.6 billion (\$2.4 billion) as of the end of 2018. Without decisive measures, the earliest the DGF could attain positive net equity would be in the 2030s and only then if no further financial crisis interferes. However, it is unlikely that the government would allow the DGF to fail and would provide funds under such circumstances. Nevertheless, the institution's

substantial indebtedness could limit its effectiveness if another significant crisis should occur.

5.12 More generally pressing problems that remain are the following:

- **Low growth.** Although growth has recovered, it is still far too low to replace the incomes lost during the 2014–16 crisis. Furthermore, no fundamental reforms have been made to the business environment to encourage additional investment, particularly by foreign investors.
- **Deep-seated political corruption and corrupt and unreliable court and prosecutorial systems.**⁶ Corruption is endemic in Ukraine, with powerful oligarchs exercising strong influence over political decisions. The court and prosecutorial systems are strongly influenced by vested interests, so there is little certainty that reliable arm’s-length contracting can take place. In the first half of 2019, the high-level courts’ ruling that the nationalization of PrivatBank was illegal and that it should be returned to its previous owner was a blow to contracting more generally. It also injects additional uncertainty into the financial system and the powers and roles of the DGF and the NBU. For example, there have been no prosecutions of related party lending, which was one of the main reasons for the banking system’s fragility in the recent crisis. Furthermore, according to interviews with Ukrainian interlocutors, the public appears to have had little understanding of the need for financial sector reform.
- **Appetite for reform.** Interlocutors interviewed in Ukraine’s public and private sectors and those within the donor community identified a distinct wavering of support within certain sectors of government for continuing to pursue fundamental reforms and particularly for tackling the deep-seated corruption that is endemic in Ukraine.
- **Political uncertainty.** The recent presidential and parliamentary elections provide an element of political uncertainty that feeds into macroeconomic risk. The views of the newly elected president toward measures currently being implemented in return for donor support are unknown, as are the views of the new cabinet and the legislature elected in July 2019. The sustainability of Ukraine’s economic recovery depends on reassuring donors and foreign investors that the government is committed to continuing with the program of fiscal and monetary restraint. Although there is no evidence that this is at risk, until the new political dispensation is in place, continued uncertainty will negatively affect investment and growth.

Bank Performance

Quality at Entry

5.13 Quality at entry is rated **moderately satisfactory**. At the outset of the crisis, the World Bank was aware of the vulnerabilities in Ukraine’s financial sector. Extensive analytical work identified potential problems, which included inadequate credit analysis, extensive borrowing denominated in foreign currency, under-provisioning for NPLs, and weak regulatory and supervisory oversight. The CPS for Ukraine for fiscal years 2012–16 identified supervisory authorities’ failure to address NPLs in the state-owned banks. It also noted the DGF’s transformation from a simple deposit insurance entity to one that had bank resolution powers as a positive step in shoring up the financial system’s resilience.

5.14 When the 2014 crisis struck, World Bank staff and other donors (particularly the IMF and the European Commission) moved rapidly to provide financial and technical assistance, with the World Bank taking the lead in the financial sector. World Bank staff should be commended for the extensive and well-targeted assistance that it provided in this area. The prior actions of DPL1 and DPL2 addressed a number of the issues identified in the CPS and in other analytical work. The measures combined to promote financial system stability and enhance the capacity of the key supervisory and regulatory institutions. As the crisis deepened in 2015, the World Bank prepared DPL2 expeditiously.

5.15 At entry, insufficient account was taken of the constraints inherent in the court system and how gaps in critical legislation such as the bankruptcy framework would inhibit fundamental recovery in the financial sector. Furthermore, the depth of the crisis appeared to have been underestimated at the outset as evidenced by the target for the “consolidation” of the financial system—only 30 banks were expected to fail. Furthermore, measures to address the state banks’ NPLs were inadequate and did not address the potential criminal liability of bank managers and their boards of directors in writing down the value of the NPLs, the principal value of which will clearly not be recovered.

Quality of Supervision

5.16 Quality of supervision is rated **satisfactory**. The World Bank participated in ongoing policy dialogue with Ukrainian authorities as part of the DPL series and through technical assistance. In particular, the latter (which is ongoing) has been important in developing deep and cooperative relationships with the NBU and the DGF, which enhanced the DPL series’ effectiveness of supervision and continues to the present.

5.17 As the crisis deepened in 2015, the World Bank adjusted the prior actions to reinforce the effectiveness of the NBU and the DGF and to provide them with additional instruments to address the banking sector's deterioration.

5.18 Bank Group staff worked closely with other development partners, particularly the IMF, to find opportunities to push the reform agenda forward either through prior actions and conditionality or by supporting the drafting of legislation and capacity building in existing agencies.

5.19 After the DPL series closure, World Bank personnel continued in-depth involvement with the DGF and the NBU. Sufficient trust had developed that they were invited to participate as observers in the selection of the advisory boards for the state-owned banks, although this was not sufficient to discourage the choice of some members closely aligned with vested interests. Interviews in Ukraine confirmed the World Bank's hands-on engagement and support was viewed with high regard. This regard increased with the proximity of the involvement of the main World Bank interlocutor, who has become a central figure in financial sector reform in Ukraine, as acknowledged by key stakeholders.

5.20 Overall Bank performance is rated **satisfactory**.

Borrower Performance

Government Performance

5.21 The rating for government performance is **moderately satisfactory**. After the Euromaidan revolution and the accession of a new government, the Ukraine authorities' attitude toward reform changed to one of close cooperation that was successful (with donor support) in restoring confidence to the financial system. Key legislation and regulatory changes were passed and implemented along with the government's involvement in supplying the DGF with sufficient liquidity to ensure that depositors in failed banks were reimbursed up to the statutory amount. These measures successfully restored confidence to the financial system, and modest growth resumed in 2016.

5.22 However, after this occurred, reform enthusiasm waned at high government levels. Key legislation stalled in legislative bodies, and although the bankruptcy legislation passed, the president only signed it before the 2019 elections; the delay violated the constitution. No effort was made to prosecute the owners of failed banks that had engaged in highly questionable banking practices; interlocutors in Ukraine indicated that some banks had even transferred depositors' funds to offshore accounts. Appendix E contains a lengthy list of legislation not yet passed as of mid-2019, even

though donors recommended them as important for ensuring the financial system's future stability.

Implementing Agency Performance

5.23 Implementing agency performance is **satisfactory**. The Ministry of Finance and the Ministry of Economic Development were the implementing agencies for DPL1, and the Ministry of Finance was the implementing agency for DPL2. Together with the NBU and the DGF, they have maintained a continued dialogue at the technical and policy levels. The strengthened technical capacity of these institutions has contributed substantially to the reforms that have occurred. Although frustrations exist regarding legislation that has yet to be enacted or implemented, there has been a level of transparency on its status that had not previously existed.

5.24 The overall borrower performance is **moderately satisfactory**.

Monitoring and Evaluation

Design

5.25 The monitoring and evaluation framework in DPL1 used five quantifiable indicators to capture results. A sixth indicator was added under DPL2 to reflect the changes to the program that were needed because of the further weakening of the financial sector in 2015. However, the quality of some indicators is weak because they did not always measure positive achievements. For example, the indicator related to bank failures, namely the number of banks handed over for resolution, could be interpreted as a positive outcome instead of a measure of the crisis severity. In addition, some important data were not included in the outcome indicators, particularly those related to the number and value of NPLs of the state-owned banks. This was a substantial omission and reflects the reform program's overall weakness regarding the role of state-owned banks in the system.

Implementation

5.26 Government counterparts were responsible for data collection, which were freely supplied to donors. Implementation and use occurred frequently and on an ongoing basis rather than through periodic reviews of the indicators.

5.27 The program document for DPL1 anticipated that the DGF would implement 20 bank resolution plans. Program document 2 noted that by the time of DPL2's approval, 54 banks had failed, which was the bank resolution number included in DPL2. However, the rate of failure actually accelerated in 2015/16, and 80 banks had failed by the end of 2016; the number of failed banks reached 95 by 2018.

Use

5.28 Program monitoring and evaluation was based more on the ongoing close dialogue among donors (led in the financial sector by the World Bank and the counterpart government in Ukraine) rather than on the use of the indicators in the DPL series' results matrix.

5.29 The monitoring and evaluation of the DPL series is rated **modest**.

6. Lessons

6.1 **Close coordination among donors is critical for DPLs to maximize the effectiveness of a jointly designed reform program.** In this DPL series, close donor coordination ensured the reform program's consistency and the uniformity of advice regarding policy measures.

6.2 **The design of DPLs needs to focus on all relevant issues, potential weaknesses, and gaps in reform measures.** There were shortcomings in dealing with state-owned banks and the contracting framework in the DPL series. Although these omissions were understandable given the need to focus on the immediate crisis response (which overshadowed these medium-term concerns), the sustainability of outcomes in the long term relies on a continued focus on such reforms in follow-up operations.

6.3 **The presence of task teams in the field can be a critical factor in promoting financial sector reform.** Country-based task team leaders can have local knowledge and the ability to engage closely with counterparts. This is an important element in planning succession.

6.4 **Weak public understanding of financial sector reforms indicates a need to expand outreach efforts to enhance political sustainability.**

6.5 **Sustainable reform is difficult to achieve in countries that have corrupt power structures and court systems.** Under such circumstances, it is an open question whether World Bank assistance risks providing additional resources for rent seeking rather than support for reforms.

¹ For selected indicators regarding exchange rates, see the International Monetary Fund website at <http://data.imf.org/regular.aspx?key=61545850>.

² The Country Assistance Strategy for fiscal years 2012–16 reported that the general government deficit in 2010 was targeted at the equivalent of 5 percent of gross domestic product but was

missed because of the deficit of Naftogaz, illustrating the connection between fiscal discipline, the losses of state-owned enterprises, and financial sector stability.

³ The 2012 Household Budget Survey estimated that 19 percent of poor households and 16 percent of the bottom 40 percent had savings in financial institutions.

⁴ This is a temporary bank established to acquire the assets and liabilities of a failed bank.

⁵ Between early 2015 and the end of 2016, the Deposit Guarantee Fund's staff increased from 200 to 399, and its budget doubled. Furthermore, most of the new staff was employed in the Department of Consolidated Sales and Asset Management, which had been created specifically to address problem bank resolution.

⁶ The level of corruption in Ukraine is exceptionally high. This can severely undermine economic growth prospects, particularly by hindering private investment. Therefore, reducing corruption is essential to speed up the process of economic convergence with the rest of Europe (IMF 2017, 3).

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Appendix A. Basic Data Sheet

First and Second Programmatic Financial Sector Development Policy
Loans IBRD-84220 and IBRD-85370

Table A.1. Key Project Data

Financing	Appraisal Estimate (\$, millions)	Actual or Current	
		Estimate (\$, millions)	Actual as Percent of Appraisal Estimate
Total project costs	1,000,000	1,000,000	100
Loan amount	1,000,000	1,000,000	100
Cofinancing	0	0	
Cancellation	0	0	

Table A.2. Cumulative Estimated and Actual Disbursements

Disbursements	FY14/15	FY15/16
Appraisal estimate (\$, millions)	500	500
Actual (\$, millions)	500	500
Actual as percentage of appraisal	100	100
Date of final disbursement	09/04/2014	09/16/2015

Table A.3. Project Dates

Event	Original	Actual
Concept review	05/14/2014 and 04/27/2015	
Negotiations	06/23/2014 and 08/20/2015	
Board approval	08/07/2014 and 09/15/2015	
Effectiveness	09/04/2014 and 09/15/2015	
Closing date	11/30/2014 and 06/30/2016	

Table A.4. Other Project Data

Borrower or Executing Agency: The Ministry of Finance and the Ministry of Economic Development and Trade were the implementing agencies for DPL1. The Ministry of Finance was the implementing agency for DPL2.

Appendix B. Prior Actions

Table B.1. Policy Matrix for the Financial Sector Development Policy Loan Program

Prior Actions under FSDPL1	Triggers for FSDPL2	Prior Actions under FSDPLS2
Pillar 1: Strengthening the operational, financial, and regulatory capacity of the DGF for the resolution of insolvent banks		
<p>Prior action 1: The DGF's financial capacity was strengthened by establishing a mechanism for long-term backup funding from the government.</p>	<p>Trigger 1: The state budget law for 2015 includes a backup funding provision for the DGF, and required funding is provided by the Ukrainian government to DGF in accordance with the latter's bank resolution and depositor payout needs.</p>	<p>Prior action 1: The DGF's financial capacity for bank resolution was strengthened by establishing a backup funding provision to DGF from the government.</p>
<p>Prior action 2: The range of bank resolution instruments was expanded and the resolution process streamlined to introduce improved provisions on, among other things, the use of bridge banks by the DGF without an identified investor.</p>		<p>Prior action 2: Authorities enabled the DGF to increase the speed of meeting its obligations to insured depositors.</p>
<p>Prior action 3: The DGF's administrative council approved a revised operational budget and a staffing plan for 2014.</p>		<p>Prior action 3: Authorities increased the efficiency of the asset management function of the DGF.</p>
<p>Prior action 4: The NBU and the DGF signed a memorandum of understanding to improve the sharing of information on problem banks between the two institutions.</p>		
Pillar 2: Improving the solvency of the banking system through implementation of bank recapitalization, restructuring plans, and timely enforcement		
<p>Prior action 5: Authorities established the key principles of the bank recapitalization and restructuring process through the adoption of a corrective action plan for dealing with undercapitalized banks, and the adoption of criteria for state participation in the bank recapitalization process.</p>	<p>Trigger 2: Regulations were adopted to operationalize the mechanism for state participation in bank recapitalization, including the details of decision-making and governance arrangements.</p>	<p>Prior action 5: Authorities have initiated updated diagnostic studies for the 20 largest banks, based on acceptable terms of reference, taking 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%) 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</p>

Prior Actions under FSDPL1	Triggers for FSDPL2	Prior Actions under FSDPLS2
<p>Prior action 6: The NBU launched independent diagnostic studies for the 35 largest banks, based on acceptable terms of references, and the 15 largest banks signed a contract with a qualified audit firm.</p>	<p>Trigger 3: Banks completed the implementation of time-bound recapitalization and restructuring plans.</p>	<p>manner, it will be transferred to the DGF for resolution.</p> <p>Authorities have created the legal mechanism for state recapitalization in cases where the resolution of a bank on a least-cost basis via the DGF could affect financial stability. The legal changes ensure that public funds are only injected after shareholders have been completely wiped out, and liabilities to bank-related parties and nondeposit 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.</p> <p><i>The NBU Decision #429, “On Progress of Implementing Activities on Capitalization Based on the Results of the Diagnostic Studies,” was adopted on July 3, 2015.</i></p>

Note: CAR = capital adequacy ratio; DGF = Deposit Guarantee Fund; DPL = development policy loan; FSDPL = Financial Sector Development Policy Loan (program); NBU = National Bank of Ukraine.

Appendix C. List of Persons Met

Organization	Persons Met
Bankers Association of Ukraine	Elena Korobkova Roman Shpek
Deloitte	Gregory Fishman
Deposit Guarantee Fund	Dmytro Sandrovski Andrii Olenchuk
Dragon Capital	Anastasia Tuyukova
European Bank for Reconstruction and Development	Alexander Pavlov
European Business Association	Anna Derevyanko Igor Gotsyk Levgenii Veremiichenko
UkrEximBank	Oleksandr Hrytsenko Oleksandr Shchur Sergiy Khudiyash
International Finance Corporation	Jason Pellmar Elena Voloshina
International Monetary Fund	Wim Fonteyne Goesta Ljungman Mariia Sydorovych
KAB Consulting Netherlands	Engin Akcakoca Emmanuel Carrere
Ministry of Finance	Yuriy Heletiy
National Bank of Ukraine	Volodymyr Kuchyn Dmytro Sologub
Oschadbank	Anton Tiutiun
PrivatBank	Engin Akcakoca
Raiffeisen Bank Aval	Vladimir Kravchenko Mykhailo Rebryk
U.S. Embassy	Suriya Jayanti
World Bank	Alexander Pankov Vahe Vardanyan

Appendix D. State-Owned Banks in Ukraine

UkrEximBank: One of three systemically important state-owned banks, it focuses primarily on financing export-import activities of Ukrainian companies. According to the state-owned bank strategy, the government would retain a majority stake in UkrEximBank in the short term but would start reducing its holding in the medium to long term.

Oschadbank: Another of the systemically important banks, Oschadbank has more than 6,000 offices and serves in nearly all sectors. Its services include the disbursement of pensions and social aid, processing of utility payments, and other banking transactions. It is the only Ukrainian bank in which the state fully guarantees citizens' deposits and other valuables by law. In addition, it is the only state-owned bank in the country that is not a member of the DGF. The strategy seeks to attract international financial institution investment for a minority position by 2020 (less than 25 percent), with the state further reducing its share to 51 percent or less through an initial public offering or a sale to international investors by 2022.

UkrGasBank: The smallest of the state-owned banks, it was nationalized in 2009. It focuses on four main business sectors—corporate business, lending to small and medium enterprises, retail banking, and consumer banking—and has more than 240 branches throughout the country.

In 2017, UkrGasBank signed a memorandum of understanding with the International Finance Corporation and the Ministry of Finance of Ukraine for preprivatization preparation. So far, the International Finance Corporation has supported UkrGasBank in its corporate governance and the refinement of its commercially driven banking model. According to the government's state-owned banks strategy, UkrGasBank is expected to be fully privatized during 2020–22. The government has stated that it wants to sell a minority stake in UkrGasBank to an international financial institution by 2019, but only limited progress has occurred as of mid-2019.

PrivatBank: The bank is the largest commercial bank in Ukraine based on the number of clients and the value of its assets. The government nationalized PrivatBank in 2016 to preserve the financial stability in the country and recapitalized it in an amount equivalent to nearly 5 percent of GDP. However, in April 2019, a court ruled that the nationalization of the country's largest commercial bank had been illegal, and NBU's request for appeal was rejected in May 2019. A substantial degree of uncertainty still surrounded the case as of October 2019.

Appendix E. Financial Sector Laws Remaining to Be Passed

The following is a list of legislation (in order of priority) that has not yet passed as of June 30, 2019, even though donors recommended them as important for ensuring the financial system's future stability.

1. **IOSCO standards:** Draft law "On amendments to certain legislative acts of Ukraine to protect investors against abuse in the Capital Markets," Reg. No **6303-d** of 06.04.2017. Approved by the Committee for first reading on June 20, 2018.
2. **DGF governance and powers:** Draft law "On amendments to certain legislative acts of Ukraine to increase the effectiveness of bank resolution, selling assets of banks, and adaptation to international standards and acts of the EU," Reg. No **6273** of 31.03.2017. Approved by the Committee for first reading on January 16, 2018.
3. **Bank liquidation procedure:** Draft law "On amendments to Article 77 of the Law of Ukraine 'On Banks and Banking' regarding the specifics of conducting a bank liquidation procedure," Reg. No. **6608** of 21.06.2017.
4. **Anti-money laundering:** Draft law "On prevention and counteraction to legalization (laundering) of the proceeds of crime, terrorist financing, and financing of proliferation of mass destruction weapons," Reg. No. **9417** of 19.12.2018.2.

To be adopted by June 30, 2019:

1. **Financial instruments:** Draft law "On amendments to some legislative acts of Ukraine on simplification of raising investments and introduction of new financial instruments," Reg. No. **9035** of 03.09.2018. Approved by the Committee for first reading on October 2, 2018.
2. **Asset resolution companies:** Draft law "On companies managing problem debt," being debated between the NBU and Rada Committees before formal submission.
3. **Banking:** Draft law "On changes to selected laws of Ukraine that regulate banking activity," under preparation.