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THE WORLD BANK – FINSAC

FINANCIAL SECTOR ADVISORY CENTER – VIENNA

May 2015

WORLD BANK GROUP

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WORLD BANK GROUP

BMF FEDERAL MINISTRY OF FINANCE

LIST OF ABBREVIATIONS

AML Anti-Money Laundering
AQR Asset Quality Reviews
BCBS Basel Committee of Banking Supervision
BEM Moldova Banca de Economii
BGF Poland's Bank Guarantee Fund
BNB Bulgarian National Bank
BoA Bank of Albania
BRRD Bank Recovery and Resolution Directive
BS Moldova Banca Sociala
CBCG Central Bank of Montenegro
CET Common Equity Tier
CRD IV/CRR Capital Requirements Directive and Regulation
CSE Crisis Simulation Exercise
DIF Bulgarian Deposit Insurance Fund
DPL Development Policy Loan
D-SIBs Domestic Systemically Important Banks
EBA European Banking Authority
EBRD European Bank for Reconstruction and Development
ECB European Central Bank
EIB European Investment Bank
ESM European Stability Mechanism
EU European Union
FinSAC World Bank Vienna Financial Sector Advisory Center
FSAP Financial Sector Assessment Program
FSB Financial Stability Board
FPM Financial Projection Model
FSC Financial Stability Council
ICAAP Internal Capital Adequacy Assessment Process
IFC International Finance Corporation
IFI International Financial Institutions
IFRS International Financial Reporting Standards
IMF International Monetary Fund
JRC EC Joint Research Centre
KTB Bulgarian Corporate Commercial Bank
NBM National Bank of Moldova
NBS National Bank of Serbia
NPE Non-Performing Exposure
NPLs Non-Performing Loans
RRPs Recovery and Resolution Plans
SRB Single Resolution Board
SREP Supervisory Review and Examination Process
SRF Single Resolution Fund
SRM Single Resolution Mechanism
SSM Single Supervisory Mechanism
NBU National Bank of Ukraine
TA Technical Assistance
WBG World Bank Group

I. FOREWORD

Significant progress has been made in addressing the "fault lines" that led to the global financial crisis. The EU is gradually implementing a new financial architecture - aiming to achieve more integrated, competitive, and, hopefully, better supervised financial institutions - while addressing the resolvability of systemic banking institutions without recourse to fiscal support, and implementing international agreements directed at enhancing the resilience of banking institutions such as Basel III and the Financial Stability Board (FSB) recommendations.

Despite progress on the new EU financial architecture, the return to "normality" still has not been completed. 2014 was a disappointing year in terms of further postponement of the long-awaited resumption of faster credit and economic growth, the reduction of non-performing loans, and better financial results for banking institutions.

New threats emerged, including the continuous deleveraging of banks and borrowers, the reduction of cross-border capital flows, the threat of rising public debt levels and potential sovereign defaults, and the dangers posed by lowflation or even deflation in several EU countries. There are rising geo-political risks, enhanced market and foreign exchange volatility, precipitous declines in commodity prices (particularly oil and metals), concerns about the decoupling of the US and UK economies from the EU and the possibly temporary strengthening of the US dollar, and other factors which risk sending financial integration into reverse. While some of these developments can be viewed positively as they represent healthy corrections from the excesses which led to the "Great Recession", others could have negative repercussions for the financial system and further delay the EU recovery. Deflationary pressures make it more difficult for governments (as well as the private sector) to service debts and resume consumption and investment growth.

These EU issues, together with countries' own idiosyncratic factors, had major repercussions in FinSAC client countries. Countries already in the EU experienced slowing economies or the inability to recover from deep recessions, particularly Croatia. The economy of South East Europe (six Balkan countries) stagnated in 2014. Increasing business cycle synchronization transmitted the slow growth from its main trading partner, the EU. A major natural disaster resulted in a flood-induced GDP contraction in Serbia (estimated to have contracted by 2 percent) and a sharp slowdown in Bosnia and Herzegovina and Montenegro. Only Albania and the former Yugoslav Republic of Macedonia, among the countries in the Balkans[1], showed signs of a more sustained recovery on the back of rising exports.

Further East, geopolitical factors and deepening banking crises (Ukraine and Moldova) affected the year's outcome. The crisis in Russia has also severely affected neighboring countries like Armenia and Georgia, which are struggling to contain the Ruble fallout.

FinSAC stepped up its activities in 2014. It provided targetted technical assistance (TA) to tackle some of the most pressing banking problems - particularly the high levels of non-performing loans (NPLs) and the resolution of non-viable banks - while addressing the medium-term institutional development needs of incorporating EU legislation and best practices into the national legal frameworks and supervisory systems. Activities focused on strengthening supervisory practices from the bottom up; decisively addressing the high levels of NPLs; crisis simulation exercises (CSEs) preparing policy-makers to confront potential distress in their financial sectors; and providing crisis assistance.

FinSAC has now matured into a regional center of excellence, increasingly focused in micro-prudential supervision, NPL resolution and banking recovery and resolution. Based on its growing experience and understanding of demand, FinSAC is moving away from the previous general four-pillar approach, to become increasingly a "niche" player. As a results-based advisory program, and to make the most effective use of resources, assistance is being focused on more selective interventions. That said, specific requests in the area of financial stability, macroprudential supervision or consumer protection will be addressed when resources permit.

[1] World Bank Group, "Coping with Floods, Strengthening Growth", South East Europe, Regular Economic Report, January, 2015.

FINANCIAL SECTOR ADVISORY CENTER (FINSAC)

The World Bank Vienna Financial Sector Advisory Center (FinSAC) was established in 2011 in response to the global financial crisis, to assist in identifying issues and problems in national banking sectors, in new EU member states and emerging European client countries, and, at the request of the national authorities, recommend tailored solutions. A core FinSAC team of specialized staff with key relevant skills and expertise is based in Vienna, funded by the Austrian Federal Ministry of Finance, working closely with staff from the World Bank's (WB) headquarters and other IFIs, as well as with Sr. international experts offering technical assistance, including implementation advice.

EU and other international policy makers coordinated their response to the global financial crisis has resulted in the introduction of a flurry of policy reforms, particularly in the area of cross border crisis management, bank recovery and resolution, NPL resolution, and bank capital and liquidity. FinSAC has responded to the need for help in implementing these reforms by deepening its expertise to offer specialized TA, in areas other TA providers do not reach or are unable to deliver. FinSAC provides independent, confidential and tailored technical expert and technical advice and implementation support to eligible client countries. This includes supporting the development of legislative and regulatory frameworks; encouraging institutional strengthening; and building the capacity of local experts through our targeted TA projects. It also helps implement the WB/IMF Financial Sector Assessment Program (FSAP) recommendations and participates in the Vienna Initiative. It offers global knowledge such as analytical reports on important banking regulatory and supervisory issues and helps develop and disseminate knowledge and good practices that can enrich regional policy debates and cross-fertilize reforms. It promotes the application of international benchmarks and standards with the support of global and regional organizations such as the Basel Committee, the FSB, the Financial Stability Institute, the European Banking Authority, and the European Central Bank (ECB). In building strong regulatory and supervisory environments, FinSAC maintains momentum in client countries at the national level through bilateral meetings, in country engagements (often in partnership with the WB country programs or other IFIs), and provides technical advice on specific issues at all levels of government and industry to reinforce the importance of financial stability and strong banking sectors, as well as through regional seminars to disseminate good practices and foster peer learning.

Since its establishment, FinSAC has followed an ambitious inception strategy of casting a very wide "net" of potential TA products to its client countries. Activities have centered on four pillars[2]: 1) financial stability, crisis prevention and macro-prudential frameworks; 2) micro-prudential regulatory and supervisory frameworks; 3) bank recovery and resolution frameworks; and 4) consumer protection and financial literacy. This approach allowed FinSAC to effectively identify actual demand, providing valuable information about the concerns and requirements for advisory services and knowledge products from its target client countries.

Productive FinSAC engagements have included addressing the enormous implementation challenges arising from the numerous Basel and EU complex regulations and initiatives. Most client countries are committed to adopting EU regulations, but have only limited access to EU institutions or other EU supervisors for guidance. Most of these regulations are also principles based, and thus pose specific implementation questions and challenges for non EU counties. FinSAC offers technical assistance in the implementation of this vast and complex regulatory agenda. We work to help implement these proposals, aligning them with good international practices as well as country specific institutional development needs and constraints.

Central banks and supervisory agencies are often reluctant to give access to sensitive confidential information in the area of banking supervision, such as banks' inspection reports, internal supervisory decisions and practices, individual banks' risk assessments, to external consulting firms. Similarly, authorities are often disinclined to give access to their own contingency plans and crisis arrangements and bank specific resolution plans. They do, however, feel comfortable working with FinSAC in these areas under strict confidentiality. Moreover, the analyses and recommendations offered by FinSAC as part of the micro-prudential pillar require multiple missions staffed by seasoned practitioners, something out of reach for the FSAP missions and other International Financial Institutions (IFI) engagements.

[2] The four pillars supporting FinSAC's activity were defined in 2012. The first pillar consists of financial stability, crisis prevention and macro-prudential frameworks. The second pillar includes micro-prudential regulatory and supervisory frameworks. The third pillar is bank recovery and resolution frameworks. The fourth pillar covers consumer protection and financial literacy.

II. OVERALL ECONOMIC AND FINANCIAL REGULATORY CONTEXT: THE EU & THE REGION

For the EU countries and candidate countries, 2014 can be characterized as a “transition year”, both in terms of the expected recovery of economic activity, as well as in terms of the new euro area financial sector institutional framework being phased-in. From the geopolitical point of view, 2014 turned out to be a watershed year, in view of the deepening crisis in Ukraine; the imposition of sanctions on Russia by the EU and the US; and the Greek crisis enterering into a new, unchartered, phase.

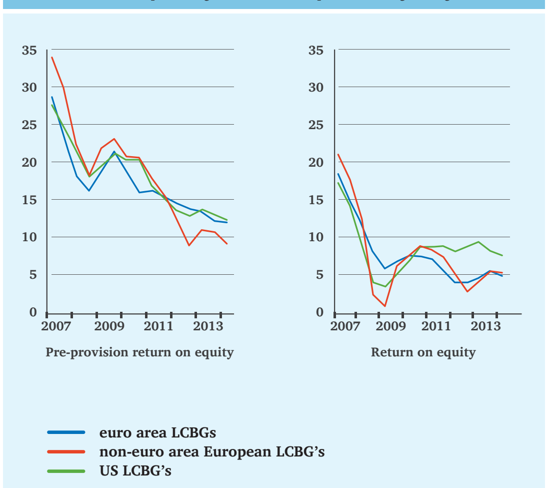
A. THE EU

There seems to be increasing heterogeneity among EU countries. Some of the crisis countries started to recover from a low base (Spain, Ireland, Portugal, and Greece), while Germany and France sharply slowed down, and Italy fell back into recession.

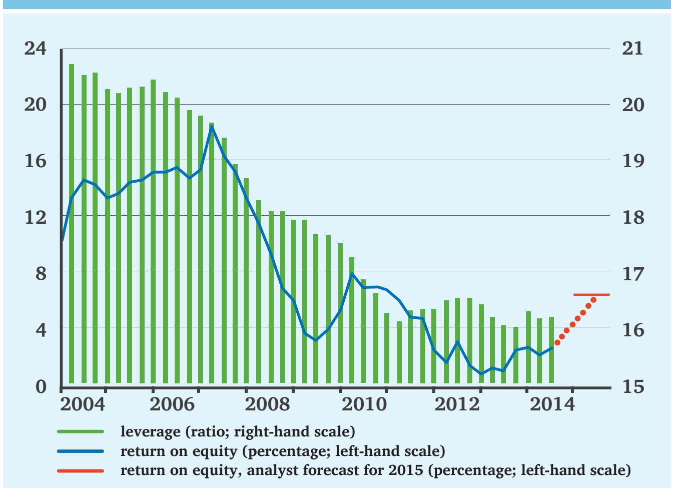
EU countries continued struggling with legacy issues from the global financial crisis. These included high unemployment; high public and private debt levels; sluggish output growth; “lowflation”; and very low interest rates, practically at the zero lower bound. There was low bank profitability; bank deleveraging; and low or negative credit growth, with signs of increasing bank disintermediation as companies started more actively to tap the shadow banking system and the incipient capital market. Addressing key policy issues has been made even more difficult in an environment of fiscal austerity and low (public and private) investment, low or declining output growth, low or falling inflation rates, and rather generalized pessimism and political uneasiness. The year ended with a welcome boost, with the unexpected stimulus for all EU oil importing countries as international oil prices fell sharply, as well as from increased competitiveness resulting from the rather steep depreciation of the Euro against the US Dollar. While welcomed in terms of potentially higher household disposable income and consumer spending, and better export competitiveness, this also brought more deflationary pressures and potential turmoil in oil/energy dependent exporters, particularly Russia, especially if low oil prices persist over 2015-17. These developments in the core EU countries have a major impact in all FinSAC client countries, both in the EU, as well as outside of the EU.

According to the European Central Bank’s (ECB) financial stability review, a confluence of cyclical and structural factors has led to a low profitability or loss-making environment for many euro area banks. Clearly, the emergence from crisis and recession in the euro area has had a significant impact – with one-fifth of euro area significant banking groups reporting losses in the first half of 2014, albeit down considerably from more than half of the banks reporting losses in the second half of 2013. Persistent weak bank profitability could become a systemic concern if it limits banks’ ability to improve their shock-absorbing capacity via retained earnings and provisioning. For many banks their return on equity has fallen below their cost of equity – shareholders’ expected rate of return – also pointing to a structural need for further balance sheet adjustment in parts of the banking system, as well as possible further consolidation to eliminate excess capacity.

Pre- and post-provision return on equity of euro area and global large and complex banking groups (LCBGs)
H1 2007 – H1 2014; percentages; medians; two-period moving average



Return on equity and leverage of euro area significant banking groups
Q1 2004 – 2015; medians



Charts from the ECB Financial Stability Review, November 2014

The risk of a disorderly and broad-based unwinding of global search for-yield flows as a result of a faster than expected exit from unconventional monetary policies by the US FED remains a cause for concern.

Things can get worse in view of: (i) Supervisors' imposition of large fines for manipulation of LIBOR rates and FX markets; (ii) legacy issues including potential claims from private agents on the losing side of the LIBOR/ FX trades; and (iii) banks faced with possible overcapacity, high costs, or limited diversification of their income sources. There is still some way to go in addressing these issues.
Banks are still heavily exposed to sovereign risks in many EU countries in the form of government bonds in their investment portfolios. Uncertainties relating to sovereign debt sustainability are likely to remain over the medium term, as government debt-to-GDP ratios are projected to stay at levels well above 100% in several euro area countries. This highlights the need for further adjustment of fiscal and economic fundamentals relevant for debt sustainability.

Bank lending flows to the non-financial private sector have remained muted, partly reflecting the ongoing balance sheet repair in both the financial and non-financial sectors. On average, bank lending to euro area households has remained subdued, mirroring sluggish dynamics of household income, high levels of unemployment and housing market weakness in some countries, while lending to the corporate sector has in general declined.

2014 was a year of remarkable institutional changes in the EU's financial regulatory and supervisory framework, with the completion of the asset quality reviews (AQRs) by the ECB, as a prior action to the adoption of the Single Supervisory Mechanism (SSM), and as a component of the Banking Union; the adoption of the Bank Recovery and Resolution Directive (BRRD); and the initial phase of implementation of the Single Resolution Mechanism (SRM) and the Single Resolution Fund (SRF).

BANKING UNION

The European sovereign debt and banking crises underlined the flaws of monetary and currency union with national banking supervision. The Banking Union began with the Eurozone summit statement of mid 2012, when EU leaders committed to "break the vicious circle between banks and sovereigns". They planned to do this by centralizing banking supervision at the ECB for major banking groups and use the European Stability Mechanism (ESM) for direct recapitalization of individual banks, if needed.

BUILDING BLOCKS OF THE BANKING UNION

The "Banking Union" consists of four interconnected building blocks: common prudential supervision; common resolution (decision and funding); common prudential regulation (Single Rule Book); and common deposit insurance. Significant progress has been achieved in all these areas, but only the SSM has been fully adopted, as of November 2014. The transfer of authority from the national level to the supra-national SSM was preceded by a financial health-check of systemic Eurozone banks to identify any legacy issues and restore market confidence. This "Comprehensive Assessment" included an AQR and a forward looking stress test, to identify and address legacy issues before the ECB assumed its new regional supervisory role.

The AQR was undertaken by the ECB and national competent authorities and covered the 130 largest EU banks, representing 82% of banking assets of Eurozone countries. Findings from the AQR were incorporated with the stress test's baseline and adverse scenarios. Banks were required to maintain a minimum Common Equity Tier 1 (CET1) ratio of 8% after AQR adjustments and for the stress-test baseline scenario, and a minimum CET1 ratio of 5.5% under the adverse scenario.

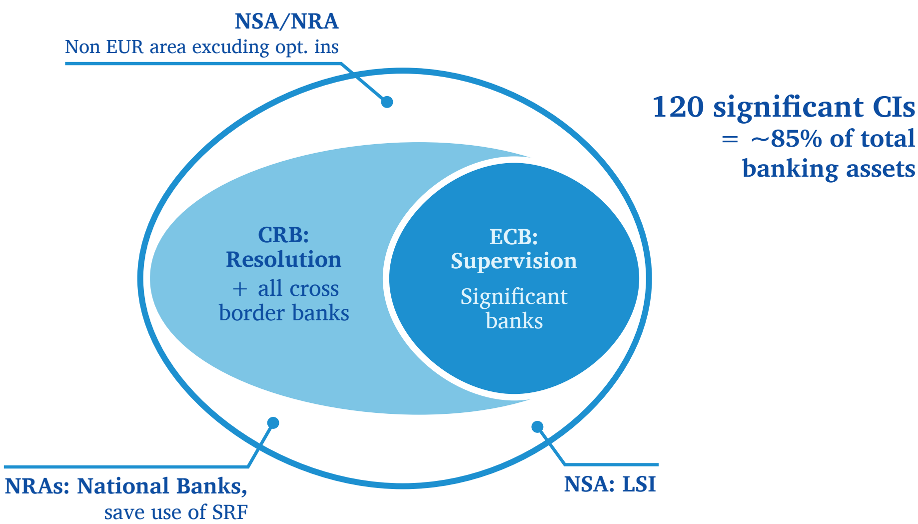
The AQR revealed that banks had to revise down their assets by €48 billion, mostly due to underestimation of specific provisions related to non-retail exposures. Additionally, non-performing exposure (NPE) stocks were increased by €135.9 billion across the in-scope institutions, as NPE definitions were moved onto a harmonized and comparable basis, including the examination of forbearance as a trigger of NPE status. The assessment identified 25 banks as having an overall capital shortfall. When all of the capital that has been raised between the assessment date and the reporting on the Comprehensive Assessment is offset against the shortfalls, €9.5 billion of equity remains to be filled, distributed across 13 banks.

With regards to the second building block, the EU has adopted the BRRD which provides for a minimum harmonized set of early intervention and recovery and resolution tools and powers, including the obligatory introduction of ex-ante financing arrangements and the nomination of a public administrative body as the resolution authority. Member States are required to transpose

the BRRD by 31 December 2014. For the euro area countries, an agreement on a SRM and a (SRF) was also reached. This should make the resolution of insolvent institutions possible at a European level and would minimize nationalizations or public support. For the SRM countries a complex web of rules and authorities has been set up with the Single Resolution Board (SRB), as a centralized decision making body, and the SRF, as a common financing arrangement, at its heart. In reality, however, the SRM is a coordination mechanism that still partly preserves national interests and relies on the implementation of the SRBs decisions by autonomous national resolution authorities. Even though the Commission and Council have veto powers in the adoption of a resolution decision by the SRB, the rare execution of these powers could endanger effective and timely decision making.
The uniform institutional framework (SRM) becomes effective as of 1 January 2015 and the SRF will gradually replace national financing arrangements as of January 2016, while reaching about €55bn in common funding by 2024.

The SRM is a necessary complement to the SSM in order to achieve a well-functioning banking union and to sever the link between banks and their sovereigns. Thus, the SRM will apply to all banks supervised within the scope of the SSM. Any Member State outside the euro area which opts to join the SSM will automatically also fall under the SRM. The SRM will be better placed to take due account of contagion and spillovers when making resolution decisions. It will also ensure a consistent application of resolution principles and tools throughout the banking union, including banks with no cross-border activity.

INSTITUTIONS UNDER THE SSM & SRM



NSA: National Supervisory Authority / NRA: National Resolution Authority
SRB: Single Resolution Board for the Euro 18+ / LSI: Less Significant Institutions

The adoption of the fourth Capital Requirements Directive and Regulation (CRD IV/CRR) in 2013 was an important step towards the implementation of the third building block: common prudential regulation or the Single Rule Book. For the first time, a set of harmonized prudential rules has been created which banks and regulators throughout the EU must respect. CRD IV/CRR will ensure uniform application of Basel III across all Member States. The CRR is a directly applicable minimum harmonization regulation; Member States are only allowed to apply stricter requirements where these are justified by national circumstances, needed on financial stability grounds, or because of a bank's specific risk profile. The latter require a strict reporting regime to the European Systemic Risk Board (ESRB). Until the establishment of a Single Rule Book, EU banking legislation was based on Directives which left room for significant divergences and discretion in interpretation and national rules. This created a regulatory patchwork, leading to legal uncertainty and higher costs, while enabling banks to exploit regulatory loopholes.

The fourth building block, common deposit insurance, has received significantly less atttention. The Deposit Insurance Directive harmonizes, as a prior action to the adoption of the SSM, the €100,000 threshold for the individual deposits covered and sets a target of a 7 day payout period. There is however no agreement on introducing a common European deposit insurance scheme for cross border banks. National deposit guarantee schemes will be much better financed to back up their guarantees, notably through a significant level of ex-ante funding: 0.8% of covered deposits will be collected from banks over a 10-year period. If the ex-ante funds prove insufficient, the Deposit Guarantee Scheme will collect immediate ex-post contributions from the banking sector, and, as a last resort, the deposit guarantee scheme will have access to alternative funding arrangements, such as loans from public or private third parties. A voluntary mechanism of mutual borrowing between deposit guarantee schemes from different EU countries is also foreseen.

IMPLEMENTATION CHALLENGES

It seems clear that the implementation challenges of the SSM are very significant. The ECB must undertake a wholly new supervisory role and set up a cadre of experienced supervisors to oversee the largest and most complex banks in the EU. It must also work towards achieving fully harmonized treatment of the various components of the banks' balance sheets, including risk-weigted assets, leverage, liquidity, NPLs definitions and provisioning, etc. For this to succeed the European Banking Authority's (EBA) role in standardizing definitions, as well as the full implementation of the Single Rule Book, is vital. Developing a common "supervisory culture" will be clearly a longer-term challenge.

Since November 4, 2014 supervision is directed by the ECB, and supported by the national supervisory authorities of participating Member States. The success of the SSM is predicated on close and effective cooperation with a rather large number of EU players, including the EBA, the European Parliament, the Euro-group, the European Commission, and the European Systemic Risk Board (ESRB), within their respective mandates, as well as the international standard setters and other bodies, including the Basel Committee of Banking Supervision (BCBS), the Financial Stability Board (FSB) and the G-20. The SSM's "growing pains" will likely be significant, and the objective of consistent supervision across all the EU countries will not be achieved immediately.

THE MISSING PIECES

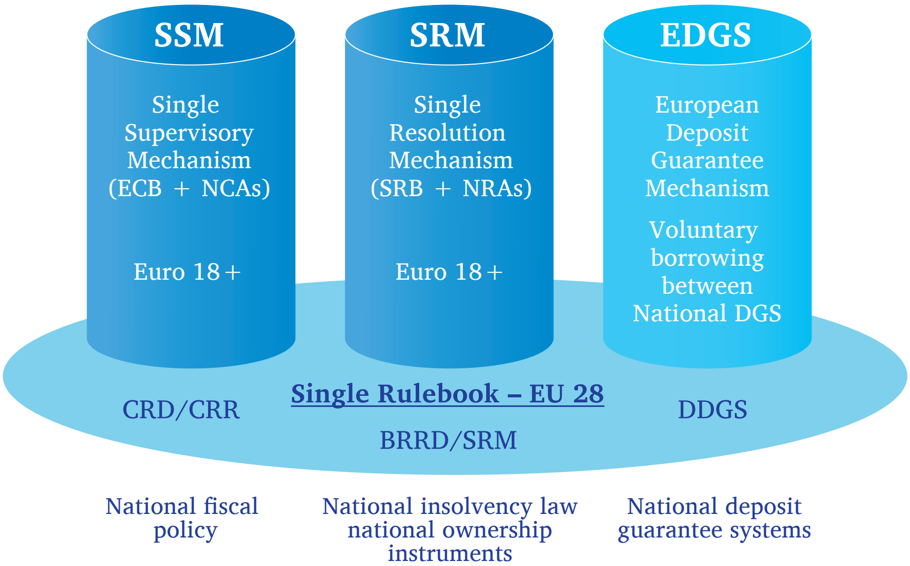
Adoption of the SSM and progress on the BRRD/SRM are important steps, but they do not yet add up to complete integrated "Banking Union". The BRRD does not offer a final solution regarding cross border burden sharing, but still relies on cooperation and coordination of autonomous national authorities. Within the SRM the vicious feedback loop between European countries' creditworthiness and that of banks headquartered in them still exists because: i) the SRF is limited by the relatively small €55 billion fund; ii) real mutualization of losses among Member States will not occur until 2024, and then only up to the fund's €55 bn. limit (plus €60 bn. ESM financing after requiring national support); and iii) the absence for the foreseable future of a fiscal union that could credibly back stop a cross border resolution and/or a common deposit insurance.

The few discretions and options available to Member States under the BRRD could have a big effect, for example the exclusion of creditors from bail-in might lead to regulatory arbitrage and does not ensure equal treatment of creditors across jurisdictions. Within the SRM the disretionary power of the SRB appears especially problematic, with stronger voting rights for Member States representing larger banks where the plenary session is invoked by individual Member States.

The absence of any plans for a common bank insolvency framework in the EU could become a future stumbling block in the event of a cross border bank liquidation, as the default option of bank resolution through liquidation remains under national legal frameworks. There is also a need to strengthen institutional frameworks and governance for the newer EU member states, particularly in the area of deposit insurance.

The decisions taken in the last two years have been important positive steps towards eliminating the vicious circle between banks and sovereigns. Meaningful progress has been made and has had stabilizing effects, but implementation of a fully fledged Banking Union remains some way off.

EUROPEAN BANKING UNION



B. EU CLIENT COUNTRIES

The state of affairs in FinSAC's EU client countries is described in more detail below.

BULGARIA

Bulgaria's banking system has shown remarkable resilience to any damage to confidence resulting from the failure of its fourth largest bank, Corporate Commercial Bank (KTB), in June of 2014. Liquidity measures taken by the Bulgarian National Bank (BNB) and the Government successfully avoided further contagion to the rest of the system. The injection of €1 billion in state resources into the Deposit Insurance Fund (DIF) allowed for the payment of insured KTB deposits, albeit with a six-month delay. KTB's failure, however, points to the need to address weaknesses in Bulgaria's supervisory and bank resolution systems to restore BNB's credibility.

KTB's crisis demonstrated that Bulgaria's legal framework did not give the authorities adequate resolution tools. A timely transposition of the BRRD into the national law has become a priority to address the gaps in the resolution and crisis management systems, as well as the recapitalization of the DIF to allow for a timelier pay-out of insured deposits. A planned AQR in 2015 also seems important to restore confidence in the banking system.

High corporate debt and high and rising non-performing loans (NPLs) and associated encumbered collateral need to be addressed promptly, including setting up an effective voluntary out-of-court debt workout system and other measures to address judicial shortcomings to timely and predictable insolvency proceedings.

CROATIA

Croatia has been underperforming in terms of economic growth, fiscal consolidation, and business environment. Croatia remains in a protracted recession for the sixth year in a row with weak prospects of recovery in 2014-15. The recession has put pressures on public finances, resulting in entry into the EU's Excessive Deficit Procedure. Although accession to the EU is expected to translate into higher investment through EU funds, there are significant challenges in their efficient utilization and implementation. At the same time, Croatian firms are less competitive, partly due to unsupportive legal and regulatory environments for businesses.

Banks, especially the smaller ones, are challenged by a shrinking sector size and lower profitability, although average capital adequacy is high. In this recessionary context, the banking sector has been shrinking in recent years. Although the banking sector is dominated by large, foreign-owned banks, it also includes numerous smaller banks. Sector profitability has been decreasing, driven by increasing provisions, declining loan quality (high and rising NPLs), and slow lending growth. The sector is liquid and well capitalized on average, but these averages may mask differences at the individual bank-level. The "overcrowded" market and declining profitability point to pressures for bank consolidation and/or exits.

NPLs have been rising and their resolution has been slow and ineffective. The quality of the aggregate bank loan portfolio has continued to deteriorate and this trend is expected to continue. The resolution of NPLs has been slow to date, partly due to an illiquid real estate market and weaknesses in the legal and judicial framework. An out-of-court pre-bankruptcy settlement process has recently been introduced, but has had little success in restructuring firms. FinSAC and the European Bank for Reconstruction and Development (EBRD) have prepared a NPLs resolution strategy and action plan to be implemented in 2015.

POLAND

Sound macroeconomic policies have helped Poland sustain economic growth throughout the global downturn. During the two recent periods of weak euro area growth, in 2008-10 and in 2013, Poland adopted counter-cyclical fiscal and monetary policies to help cushion the impact on the domestic economy. Despite a decline in domestic demand, particularly investment, Poland is the only EU country that has grown continuously over the last six years. In 2014, economic growth strengthened in Poland and the authorities resumed their fiscal consolidation efforts in an effort to start rebuilding prudential fiscal buffers, reducing the fiscal deficit to around 3.2 percent of GDP.

To sustain the recovery the authorities have prioritized reforms to strengthen public finances and financial sector oversight, while structural reforms aim to bolster the economy's long term competitiveness. Challenges remain to achieve sustainable growth: future growth is less likely to rely on relatively cheap labor, with a large share of exports to Germany as part of their export-led supply chains. The new macroeconomic framework is therefore designed to help Poland cope with future shocks, while strengthening labor markets (in terms of both flexibility and raising participation rates), the business environment and promoting innovation. Continuing to bolster financial sector oversight (including macro prudential supervision) will also support a more sustainable recovery in credit and investment and further reduce risks from such factors as the divergent monetary policy in the EU and US or from regional geopolitical instability.

In the financial sector the authorities are committed to enacting the Law on Macro-Prudential Oversight, adopting amendments to the Banking Law to incorporate the EU Capital Requirement Directive (IV), passing a new Bankruptcy Law and amending the 1997 Law on Covered Bonds and Mortgage Banks. Due to difficult legal issues, particularly possible constitutional impediments, the BRR Law included in a new Law for the Bank Guarantee Fund (BGF), drafted with World Bank (WB) assistance, is still under discussion and is likely to be delayed for another year to be considered by the new Parliament following the October 2015 elections.

ROMANIA

Prior to the 2008 global financial crisis, Romania achieved high rates of real GDP growth averaging more than 6 percent per year. Romania suffered a deep, V-shaped, GDP contraction in 2009, with a slow recovery in the following years. Under the 2009 IMF Stand-By Arrangement, Romania's economy stabilized, external and structural fiscal imbalances were substantially reduced, and initial signs of growth emerged. Structural reforms are starting to bear fruit, although they remain incomplete. In 2013 the economy recovered reaching a real rate of growth of 3.5 percent. By regional standards, Romania has had a remarkable recovery, although it still has one of the lowest levels of per capita income in the region and a notably slow pace of convergence to the EU mean compared to its peers. In 2014 domestic demand is expected to gradually overtake net exports as the main driver of growth. Investment is projected to regain momentum, supported by better absorption of EU funds, as major infrastructure projects move ahead, although the consensus forecast is that GDP growth will be under 2 percent for 2014 as a whole.

The financial sector of Romania is mostly bank-based and foreign owned, and therefore exposed to deleveraging pressures. Banks have lost external funding equivalent to 11 percent of GDP since the first quarter of 2009, which has not been fully compensated by greater mobilization of domestic funding. Although the funding structure of banks has continued to improve, deposits are predominantly short-term, posing challenges in terms of maturity mismatches with lending.

Bank credit growth continued its negative trend in 2014, reflecting persistent bank deleveraging as well as demand factors. On the supply side, parent banks adjusted their balance sheets due to new capital requirements, while subsidiaries tightened their credit underwriting standards, and cut lending due to the lack of medium and longer-term Leu funding. Demand factors included slow output growth, increased weighting of debt service of households and balance sheet weaknesses of individual borrowers and SMEs. The prevailing political and policy uncertainty has not helped.

NPLs in Romania have reached a historical high, but banks are gradually selling at a significant loss their portfolios of bad loans. The NPLs ratio in February 2014 reached 22.52 percent. Banks have taken steps to sell significant portions of their NPLs, after the authorities allowed them to write off fully provisioned non-performing loans.

C. EU CANDIDATE AND POTENTIAL CANDIDATE COUNTRIES

The South East European economies have stagnated in 2014 on the back of increasing business cycle synchronization with the EU, and flood-induced contraction in Serbia and sharp slowdowns in Bosnia and Herzegovina and Montenegro. This weak regional economic performance masks notable differences among the Southern European countries. In 2014, the Serbian economy is estimated to have contracted by 2 per cent – for a third time since the global financial crisis – and Bosnia and Herzegovina is stagnating. Economic growth rates in Kosovo[3] and Montenegro are estimated to have moderated in 2014. Only Albania and the FYR Macedonia showed signs of a more sustained recovery on the back of increasing exports, particularly in the second half of the year. The floods in May 2014 were the main immediate culprit behind the weak domestic demand and the overall sluggish economic performance.

The financial sectors of the Western Balkan countries remain fragile. Many countries are confronted with levels of NPLs that have been rising over the past years and are now very high by international standards. Even though on paper bank capital levels are generally sound and most banks have set aside significant provisions, the potential losses on these loans could reduce bank capital and profits. Additionally, banks remain cautious to lend, which hampers economic growth in the region. Some countries attribute the slowdown in subsidiaries of EU banks granting credit domestically to tighter policies from the parent bank. There is scope in a number of countries to further strengthen the legal frameworks, crisis management tools and procedures, and institutional governance to increase the authorities' capacity to effectively manage a banking crisis, particularly if it were systemic. The weak economic recovery in Western Europe and the economic conditions in other regions would complicate and delay the potential takeover or orderly exit of weaker banks in the region.

The share of Greek banks in total bank assets remains elevated in Albania (17 percent), FYR Macedonia (22 percent) and Serbia (15 percent), although the local subsidiaries are well capitalized. The ongoing problems in Greece have spurred banking supervisors in these countries to implement increased supervisory monitoring, as well as regular stress tests, assessing the potential negative impact. The above average NPLs of Greek subsidiaries and the risk of contagion can be an additional source of vulnerability.

High levels of NPLs pose significant challenges for the authorities. While the causes are unique to each country, the following common factors can be identified:

- Enforcement of collateral tends to be a long, uncertain and costly process and relies heavily on rather unpredictable and slow court decisions. This legal process is slow due to, for example, the need to organize auctions with bidding, difficulties in identifying the ownership of the collateral;

- Lack of fair frameworks for voluntary out of court restructurings for viable exposures, such as mediation services and dispute resolution;

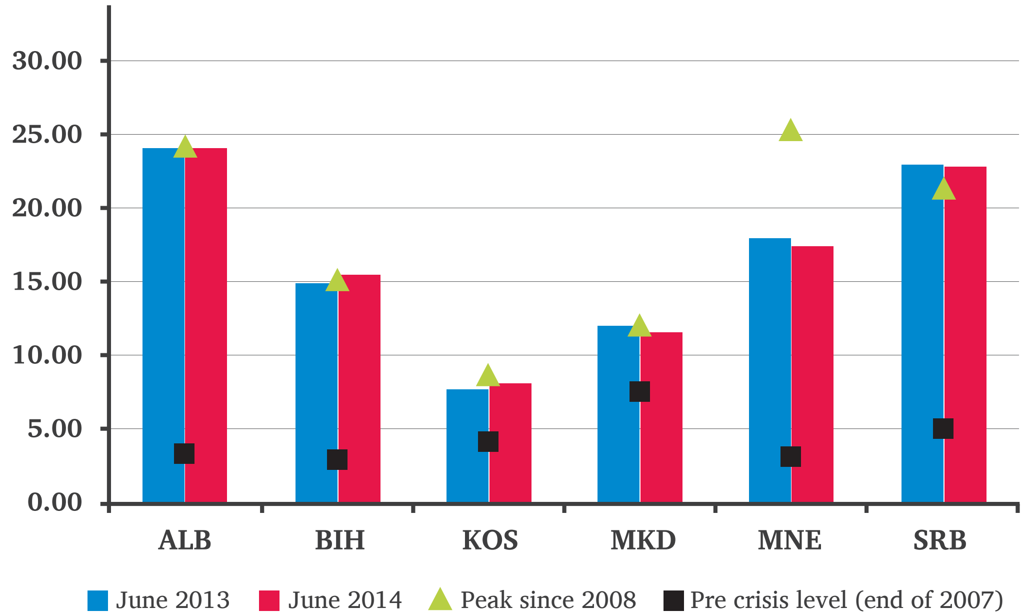
- Prudential supervisors tend not to be proactive and intrusive enough, particularly when the exposures are fully provided for. They should be more hands-on, requiring banks to set minimum target ratios for NPL resolution, discouraging the commonly adopted "wait and see" attitude of some banks;

[3] This designation is without prejudice to positions on status, and is in line with UNSCR 1244 and the ICJ Opinion on the Kosovo Declaration of Independence.

- Underdeveloped markets for distressed assets in the region tend to further limit the scope for NPLs resolution; and

- Lack of financial capacity in the bank to absorb the losses, particularly when banks are building-up capital buffers to comply with stricter Basel III requirements, can require close cooperation with the relevant authorities or other donors to resolve the bank.

WESTERN BALKANS: NON-PERFORMING LOANS, PERCENT OF TOTAL LOANS



There is an urgent need to restore credit growth and clean up balance sheets. In the NPLs area, FinSAC works closely together with other EU institutions and IFIs (the IMF, the European Investment Bank (EIB) and the EBRD) as part of the Vienna Initiative, which aims to improve banking systems and coordination among banking supervisors in the EU and non EU countries. During the 2014 WB/IMF Annual Meetings in Washington DC, it was agreed that there will be closer coordination among the IFIs in the area of NPL resolution at the country level to avoid duplication and providing conflicting advice. The first test case was the joint mission to Croatia (see Section IV, c of this report) and Serbia.

FinSAC has been particularly active in Albania in NPL resolution, where it has engaged two consulting firms to coordinate, train and prepare financial restructuring plans with the Bank of Albania (BoA) and the commercial banks leading to the actual resolution/restructuring of the thirty largest corporations/conglomerates with a high concentration of NPLs (over one-fourth of total NPLs) - See below.

In view of the strong financial links between banks and the sovereign in general, and in the Balkan region in particular, the financing of resolution tools will be a key element for their successful application. The setting up of separate funding and / or the extent and conditions of the use of deposit insurance under resolution requires a tailored approach. Also the potential reimbursement of creditors invoking the “No Creditor Worse Off” than under liquidation principle is to be carefully considered, in those cases where no separate ex ante financing of resolution funds is opted for, as in Serbia’s case.

D.UKRAINE AND MOLDOVA

UKRAINE

Ukraine faces enormous geopolitical and economic challenges, including a systemic banking crisis. Devaluation and political uncertainty have caused significant deposit outflows and deterioration of the bank credit portfolio in 2014. 33 banks were sent to resolution, including some medium sized and big banks, and given the accelerated negative developments in the market other banks may become insolvent in 2015. The Deposit Guarantee

Fund is facing significant operational and funding problems in the present crisis environment which the government has been addressing. One of the major weaknesses in the banking sector resulted from poor corporate governance and shortcomings in the supervisory regime which led to a very high level of related-party lending and increased other risks in the system. The work of the WB and the IMF has concentrated on stabilizing the situation, dealing with clearly insolvent and unviable banks, while putting in place a new financial stability and regulatory framework. This should address the major deficiencies observed in the past, including poor coordination among the government agencies National Bank of Ukraine (NBU) and the Ministry of Finance, which will now formally coordinate policies and cooperate in the Financial Stability Committee), as well as tackling the critical issues of related parties' lending, increased responsibility of bank owners and managers, and special regulatory framework for systemically important banks. To ensure the financial stability of the banking system the NBU plans to run another round of bank diagnostics and related parties' mapping exercise in large banks, to assess recent deterioration of banks' portfolios and come up with reliable bank restructuring and recapitalization plans.

Another stream of work deals with the resolution of the very high level of NPLs, adopting legal and regulatory reforms and a set of more effective mechanisms to deal with corporate bankruptcies (adoption of the "Istanbul Approach" in cooperation with the EBRD). FinSAC has a dedicated, Russian-speaking, staff working on Ukraine, preparing a series of Development Policy Loans (DPLs), as well as coordinating our TA efforts.

MOLDOVA

A financial pyramid scheme carried out by three Moldovan banks is coming to a conclusion that may cost the government's budget as much as 15% of GDP or more. The three banks involved, Banca de Economii (BEM), Banca Sociala (BS), and Unibank (UB), are believed to be controlled by a Moldovan business tycoon and his associates, with senior political patronage. Moldovan authorities are seeking to untangle a complex web of financial relationships among the three banks, their offshore correspondent banks, shell companies domiciled abroad (including the UK), and their borrowers. BEM is considered by some to be a systemic bank because of its large role in the payment system (e.g. it is a key channel for Government social payments and pensions and the sole clearing bank for the Moldova Visa and MasterCard payments) and as of September 30, 2014, held 14.4% of the system's deposits (with about 1 million active retail deposit accounts[4]), and the largest branch network. At the same date, BS held 7.1% and UB 3.2% of the system's deposits. Neither SB nor UB is considered to be systemic, but these three banks jointly represent about one quarter of total bank deposits, posing a major stability risk.

The National Bank of Moldova (NBM) has imposed a Special Administration regime on the three banks, and it has received TA from the WB and FinSAC to conduct a crisis simulation exercise (CSE), undertake a financial diagnostic of these banks, and lay out a bank resolution strategy. The NBM has also requested bids from international auditing firms for a forensic audit of three banks in order to identify the culprits, expose domestic and cross-border irregular transactions, and eventually file criminal charges against the responsible bank controlling shareholder and senior bank managers.

E. THE CAUCASUS

ARMENIA

Armenia's economic environment became more difficult in 2014, particularly due to adverse external developments affecting exports and remittances. GDP growth is expected to slow to 2.6 percent. Head winds include geopolitical developments in the region (Russia, Ukraine, Nagorno-Karabakh), the continuation of the standstill with Turkey, and stagnation in the EU. Currency pressures reemerged in November, in the context of sharp depreciation of the Russian ruble, and lower remittances and exports to Russia, leading again to CBA intervention, as well as depreciation of the Dram.

The IMF reports that the Armenian banks have excess liquidity and they remain well capitalized, although a recent increase in NPLs warrants monitoring. The banking sector remains profitable, but performance has weakened. Slower economic growth has been accompanied by an increase in NPLs, which reached 6.5 percent in September, a reduction of profitability, slower credit and deposits growth, and a small reduction in the capital adequacy ratio. In addition, competition among banks for clients in a weaker economic environment has reduced lending-deposit spreads, putting additional downward pressure on profitability.

GEORGIA

Georgia's economy has been hit by a combination of severe external shocks: the Russia-Ukraine crisis, the deepening recession in Russia and currency

[4] BEM has a further 1 million inactive retail accounts. These accounts consist of Soviet era deposits, generally in tiny nominal amounts per account, the true value of which is determined by an annual Government decision on an index. This scheme effectively makes these legacy "deposits" nothing more than another Government budgetary transfer, which could be done with payments through the Post Office or other banks.

devaluations in trading partner countries. Because of these shocks, Georgia's exports are 30 percent lower than one year ago, and remittances from Georgian workers abroad are down 25 percent.

The economy is slowing as a result. GDP growth in 2015 could reach 2 percent, however, the economies of many of Georgia's main trading partners are slowing by even more, and the depreciation of their exchange rates is hurting Georgia's competitiveness. Lower exports, remittances, and tourism receipts, have increased the current account deficit in 2014 to around 9.5 percent of GDP. As a result, the Lari has depreciated by more than 20 percent against the US dollar since January 2014,increasing the cost for those who have borrowed in foreign currency, slowing down economic growth further.

Georgian banks are well capitalized and liquid. The system is quite concentrated with a few locally-owned banks, particularly Bank of Georgia, controlling a large share of total bank assets.

Georgia had a FSAP Update in 2014, in which a number of recommendations were made. FinSAC is willing to assist the NBG in implementing them, as well as collaborating in setting up a Deposit Insurance Fund, as agreed between the Georgian Government and the EU.

III. FINSAC ACTIVITIES IN 2014

A. STAFF

In December 2014, the core FinSAC team consisted of seven staff based in Vienna, including the Coordinator. FinSAC had some turnover in 2014. FinSAC's coordinator retired in June and one staff resigned. The Coordinator was swiftly replaced and the search was a new Sr. Supervisor was started. Three additional staff were hired, one focusing on NPL resolution, another mainly dealing with the response to crisis countries, particularly Ukraine, and a lawyer with expertise in BRR was hired. FinSAC staff skills and expertise include economics, finance, law, supervision and regulation, accountancy, and risk management. The staff are supported by WB headquarter senior staff as well as Sr. international consultants, as needed. The hiring of one senior bank supervisor is foreseen for Q1/2015.

B. PUBLIC PROFILE AND BUDGET DISCIPLINE

To increase its visibility and public profile, FinSAC has developed and populated a website WWW.WORLDBANK.ORG/FINSAC and developed a range of dissemination (printed) and business line brochures for its clients. The website contains a summary of services offered, as well as the presentations of seminars and working papers.

Two marketing brochures were developed and posted on FinSAC's website. The first, which is also available in printed form, is a general introduction to FinSAC, outlining its mission, product range, geographic reach and client feedback. The second focuses on FinSAC's best known product, the CSE, explaining the process, outcomes, results and expectations. It has been used in an actual CSE to give participants an understanding of the overall purpose of the exercise and inform them about the process to be followed.

Two other product specific brochures, on micro prudential supervision and addressing recovery and resolution, are being developed.

Increased standardization and project discipline is being applied to all FinSAC's activities. As operations expanded, a simplified internal operational procedure has been developed and adopted. This standardizes project preparation, appraisal and quality control processes, providing a template for **Project Concept Notes**, facilitating the preparation of the Results Framework. This approach is mandatory for all FinSAC activities and will help maintain project focus and discipline, enhance the quality of tasks at entry/inception, and maintain accountability regarding within-budget deliveries.

FinSAC continues to work closely with relevant international organizations and agencies. For example, following a visit to the Joint Research Centre (JRC) of the EU Commission in ISPRA potential areas for cooperation, like stress testing and financial modelling, are being discussed.

C. SEMINARS, CONFERENCES AND WORKING PAPERS

1) FinSAC International Conference on Financil Consumer Protection and Financial Literacy – June, Sofia, Bulgaria

From 11 to 14 June, 2014, FinSAC organized a conference in Sofia, Bulgaria, on Consumer Protection and Financial Literacy for regional senior supervisors and regulators. It sought to enhance their knowledge and encourage debate with academics, practitioners and policymakers on the effectiveness of various initiatives being implemented in their respective countries. Six broad topics were addressed:

- Compliance and Supervision;
- Responsible Lending and Debt Counseling: A European Perspective;
- Financial Innovation and Technology;
- Approaches to Alternative Dispute Resolution in Developed and Developing EU Economies;
- Deposit Insurance and Financial Consumer Protection, and
- Strengthening the Population's Financial Capability.

Participants acknowledged that recovery of consumer confidence in the financial sector is crucial for the viability of new bank funding models which will be less reliant on cross-border and wholesale financing and more dependent on a local retail deposit base. There is a need to collectively redefine consumer relationships with the financial system in Europe to address the challenges of the recent crisis, and better prepare for the next.

The conference promoted international co-operation to support the strengthening of financial consumer protection in line with, and building upon, the G20 approved principles. There was support for increased legal recognition of financial consumer protection by oversight bodies, and achieving fair treatment of financial service users, proper disclosure, prevention of fraud and abuse, adequate complaints handling and redress mechanisms and, more broadly, the adoption of policies by financial service providers of responsible business conduct.

More information is available at:
WWW.WORLDBANK.ORG/FINSAC

2) Working Paper on Loan Classification and Provisioning: Current Practices in 26 European and Central Asian Countries

FinSAC issued its first working paper, explaining the regulations and practices in the area of identifying and provisioning for loans losses in 26 countries in EU countries and Emerging Europe. The analysis is based on the WB Survey 2011-2012. Banking supervision responses were validated through a desk review of publicly available regulations.

This working paper had three objectives. First, analyzing some important considerations that make the comparison of NPLs ratios and provisions across jurisdictions so challenging. Second, explaining the interactions between provisioning frameworks based on prudential regulations and accounting standards. Finally, concluding by sharing some good practices for NPLs definitions useful for prudential supervisors who are considering aligning their prudential frameworks more closely with International Financial Reporting Standards (IFRS) and proposing steps for further regional work, knowledge sharing and harmonization.

3) FinSAC Conference on Credit Risk Management and Regulatory Provisioning in an International Financial Reporting Standards (IFRS) Environment, October, Vienna, Austria

Following publication of the working paper, FinSAC hosted a successful conference on Credit Risk Management and Regulatory Provisioning in an IFRS Environment on October 21-22, 2014 at the Austrian Federal Ministry of Finance in Vienna. More than forty-five senior participants from central banks and regulatory agencies from ten countries in the ECA region, international financial institutions (IFIs) and the Austrian Ministry of Finance attended this event.

The seminar gave an overview of current regulatory practices for defining and provisioning NPLs in the Europe and Central Asia region and considered commercial banks' current IFRS provisioning practices. There was discussion of the pre-requisites and strategies for better aligning regulatory and IFRS provisioning incentives and practices and for the strategies being followed to accommodate traditional regulatory provisioning systems and IFRS provisioning in view of the new IFRS 9 standard. The importance of having common definitions and the early recognition of credit losses was recognized using the experience and supervisory lessons from some crisis countries with asset quality review programs, in particular Spain and Ireland, and their loan loss provisioning practices. Other topics included home-host cooperation and consolidation of financial and regulatory reports; the implementation considerations of the new IFRS 9 standard; the modelling of credit losses from the perspective of commercial banks, regulators and IFIs; the main policy alternatives and strategies for implementing reforms in accounting, disclosure, prudential supervision and reporting.

Regulators, international financial institutions (International Monetary Fund and the WB), the EBA, central and commercial bankers, consultancy firms and rating agencies, provided their perspectives on IFRS provisioning, NPLs identification and regulatory provisioning.

D. CLIENT SPECIFIC ACTIVITIES

PILLAR 1: FINANCIAL STABILITY; CRISIS PREVENTION AND MACRO-PRUDENTIAL FRAMEWORKS

One of FinSAC's most popular products under this Pillar is the financial CSE. These exercises provide the opportunity for client country authorities to test their crisis preparedness, to identify gaps in their early crisis response and bank resolution frameworks, and to assess how well different authorities can cooperate in a stressed or crisis situation. FinSAC conducted three CSEs, in Moldova, FYR Macedonia and Armenia, during

2014. They offer a good illustration of how valuable this product can be for our clients, especially if they are facing an impending crisis situation. With the benefit of hindsight, one can say that the timing of all three CSEs in 2014 proved to be exceptionally fortunate.

ARMENIA

Armenia's financial system has shown no signs of serious stability problems in the past couple of years. Given the very strong trade and remittance links with Russia however, where a sinking oil price, Western sanctions and other factors resulted in a sharp fall of the Russian Ruble in addition to other economic problems, it made sense for the authorities to practice how to cope with a sudden escalation of these adverse trends. The CSE took place in late October at the CBA's Research Centre in Dilijan, with the participation of about 40 staff from the CBA, the Armenian Ministry of Finance and the Deposit Guarantee Fund. This experience was to prove useful when the Russian Ruble tumbled in December with contagion reaching Armenia, requiring the Central Bank and other authorities to implement a set of extraordinary measures in order to manage the crisis. The de-briefing two days later allowed a valuable exchange on the preliminary observations and potential gaps identified during the CSE. The full Report will be shared with the CBA for their review and comments.

BOSNIA-HERZEGOVINA

A credit risk model to strengthen the stress testing framework at the Central Bank of Bosnia-Herzegovina (CBBH) was delivered to the client in early 2014. Staff at the CBBH was trained how to make regular use of the model and how to interpret its results for decision-making. The delivery of this TA module was a joint effort of FinSAC and the Joint Vienna Institute (JVI) with one JVI staff participating in the model building process. FinSAC also built and delivered an early warning model for the Bosnian financial system.

Also, in 2014 an update of the credit growth forecasting model suite took place, making use of new data available at the Financial Stability Unit. The results of the update were delivered to the client and were instructed on how to incorporate the new models in their everyday practice.

FYR MACEDONIA

FYR Macedonia is one of the countries in the Western Balkans where Greek banks have a strong presence. The Macedonian authorities have been intensively updating the country's crisis preparedness framework for the past two years, with help from the WB, and felt it timely to test their new arrangements, asking for a CSE with FinSAC's assistance in September. The experience and the lessons learned are helping them to deal with the new wave of possible contagion from Greece that re-emerged at the end of 2014 and at the beginning of 2015.

The CSE took place in September 2014 in Skopje, with the participation of about 40 staff from the NBRM, the Ministry of Finance and the Deposit Guarantee Fund. The exercise included a very productive de-briefing to discuss preliminary observations and potential gaps in terms of policy tools and reaction times for the different bank cases examined during the exercise. A full CSE Report was shared with the NBRM for their review. The report benefited from comments by the WB's internal peer reviewers, the NBRM, the Ministry of Finance of the Republic of Macedonia and the Deposit Insurance Fund.

MOLDOVA

Following FSAP findings and at the urgent request of the NBM a financial CSE was carried out in Chisinau in April 2014 with the participation of around 30 staff from the authorities including the NBM Governor, Deputy Governor, the Minister of Finance and the Director of the Deposit Guarantee Fund. Subsequently, the information flow and the actions taken during the CSE were carefully analyzed and a comprehensive CSE Report, outlining the main lessons and policy recommendations, was sent to the authorities for their review and comments.

UKRAINE

FinSAC participated in joint WB – IMF missions to Ukraine as part of the crisis response program. FinSAC provided TA on NPL resolution, enhancing bank capital requirements, a special regulatory regime for domestic systemically important banks (D-SIBs), as well as a recovery planning framework for D-SIBs.

The country authorities requested FinSAC's assistance to help the NBU in their efforts to establish a high level Financial Stability Council (FSC) as a platform for regular discussions of financial stability issues, with the participation of the Ministry of Finance, the Deposit Guarantee Fund, and two other financial regulators. The authorities were specifically interested in the mandate and functions of the Committee and how best to institutionalize the work of the FSC Secretariat which is to be established in the NBU. FinSAC provided extensive comments on a draft Presidential Decree setting up the FSC. Additional TA topics have been discussed with the NBU, both under FinSAC's macro and micro-prudential activities.

PILLAR 2: MICRO-PRUDENTIAL REGULATORY AND SUPERVISORY FRAMEWORKS

ALBANIA

FinSAC has been collaborating with the Bank of Albania (BoA) since 2013 to identify and implement measures that will facilitate the reduction of the NPLs stock in the Albanian banking sector, and encourage the resumption of lending to viable companies and households. The priority has been the effective enforcement of creditors' rights, while promoting the return of operationally viable borrowers to sustainable debt servicing capabilities, and hence to new sustainable borrowing.

With these aims in mind, the BoA and FinSAC have promoted the appropriate restructuring of large, economically viable corporate debtors. This required the BoA to adopt a more intrusive role in tackling coordination failures between the major creditors, while also helping banks develop their skills and expertise in operational and financial restructuring. This was achieved through a framework for the voluntary, out-of-court (VOOC) restructuring of large, complex, multi-creditor defaults, in line with the INSOL principles on multi-creditor workout, as well as the London and Istanbul experience, adapted to the specificities of the Albanian context.

This work was complemented by an innovative pilot program to evaluate the restructuring potential of the largest, most complex corporate defaults. This program, which brings together the largest Albanian banks, is hosted and managed by the BoA, with support from FinSAC through the engagement of two restructuring specialist firms with extensive experience both in Western and Central & South Eastern Europe. Under the program, banks with shared exposures cooperate in creditor committees, exchange information and analysis, and jointly negotiate with the debtor to ensure transparency and fairness in recovery. Defaulted companies in the pilot sample are evaluated based on their current financial statements and future business prospects to determine their commercial viability, as well as the level of debt that can reasonably be supported by future earnings. This is then used to decide whether the enterprise value of the company is greater than its liquidation value, in which case a restructuring is pursued.

By the end of 2014, a first sample of 13 defaulted corporate obligors, representing approximately 15% of total NPLs in the system, had been reviewed through the pilot program. Approximately one third coming out with restructuring plans were deemed to have a high chance of success, one third were deemed "worth restructuring" but there was some uncertainty about their prospects, and approximately one third were deemed unfit for restructuring and sent to liquidation. A further sample of 25 corporates will be reviewed by the BoA, FinSAC and the external consultants in March – April 2015, representing another 10 percent of the stock of NPLs. After this the participating banks are expected to continue managing the process without external support to reach a coverage of about 50 companies or conglomerates, over one quarter of the NPLs in Albania. Factors exogenous to the project led to some delays in 2014, but the project, overall, has demonstrated the importance of overcoming collective action and lack of information problems.

FinSAC presented on the NPLs Reduction Program at the Bank of Albania-IMF Country Forum in March 2014.

BULGARIA

At the request of BNB a FinSAC mission visited the Banking Supervision department of the BNB on June 15, 2014 to advise on: (i) migrating BNB's loan classification and provisioning standards to IFRS provisioning; and (ii) transferring the WB's Financial Projection Model (FPM) - by the author of the model- to assist supervisors analyze and simulate banks' performance for regulatory analysis and stress-testing purposes.

The development objective of this dual TA activity was: (i) to strengthen the practices followed by the BNB in supervising loan quality, once the regulatory loan-loss provisions was abolished and additional capital buffers were introduced, while the system transitions to IFRS provisioning in which great discretion is given to commercial banks to set their loan-loss provisions; and (ii) to transfer the FPM, a key tool for assessing the condition and viability of Bulgarian banks.

The recent intervention and nationalization of KTB, the fourth largest commercial bank, coincided with the mission's visit to Sofia, but was not part of its assistance. It is likely the BNB will request further support from FinSAC.

CROATIA

A joint WB - FinSAC and EBRD NPLs diagnostic mission visited Zagreb from 1 to 5 December, 2014 to conduct a diagnostic of impediments to NPLs resolution in Croatia and identify priority areas for intervention, which will eventually be used to define technical assistance (TA) and other support that can be provided by the WB and other IFIs. The diagnostic visit was conducted in collaboration with the EBRD and the International Finance Corporation (IFC), in the context of the Vienna Initiative. The team conducted interviews with a wide range of stakeholders including the Croatian National Bank, government ministries, state institutions; the judiciary, leading banks (representing ca. 2/3 of all Croatian bank assets), law firms, accounting and audit firms, and private investment firms.

FinSAC and the EBRD have been asked to support the insolvency law amendment process, with a follow-up visit scheduled for January 2015.

GEORGIA

The National Bank of Georgia (NBG) requested TA with the prudential implications of transition to IFRS. FinSAC reviewed the gap analysis prepared by the NBG and provided recommendations on the pace and timing of transition to IFRS in the banking system, taking into account the state of preparedness of the smaller banks. FinSAC also proposed an action plan for IFRS transition including the definition and implementation of prudential adjustments, filters and reclassifications to the IFRS financial statements of Georgian banks, based on the position of other prudential standard-setters and regulatory bodies, such as the EU and the Basel Committee on Banking Supervision.

MONTENEGRO

FinSAC assisted the Central Bank of Montenegro (CBCG) to organize an international conference launching the "Podgorica Approach" - a framework for voluntary NPLs resolution. The conference was attended by 122 participants, including representatives of the CBCG, the Ministry of Finance and various other Montenegrin government bodies, the WB and the EBRD, as well as commercial banks, international restructuring experts and investors.

SERBIA

FinSAC provided significant TA to the National Bank of Serbia (NBS) to improve the efficiency and effectiveness of onsite prudential and Anti Money Laundering (AML) supervision practices. The team interviewed bank supervision staff, on-site examiners, risk experts and other stakeholders. Current policies, procedures and supervision manuals for on-site examination and their implementation were discussed and reviewed. The assistance covered the procedures for determining the scope and frequency of inspections, the planning of inspections, the preparation and content of Inspection Reports, and the review of loan portfolios by sampling during on-site inspections. Recommendations for improved oversight of external auditors and the use of other experts were also made.

The confidential FinSAC report was discussed in a closing meeting with the Governor and the Senior Management of the NBS, with participation from the FinSAC team and Coordinator. The NBS confirmed its commitment to implement proposed changes to onsite examination procedures. A supplementary report covering specific AML issues will be prepared, as the AML supervisory process has many similarities with prudential supervision.

FinSAC provided TA to the NBS in reviewing the Internal Capital Adequacy Assessment Process (ICAAP) and improving the efficiency of the Supervisory Review and Examination Process (SREP) dialogue – Pillar 2. The work covered six areas: (i) using ICAAP/SREP as a supervisory tool, (ii) risks to be considered, (iii) calculation of capital requirements, (iii) stress testing, (iv) available capital, (v) capital adequacy, and (vi) other issues. Specific proposals on each topic were made for NBS consideration.

It should be noted that the NBS gave full access to confidential information to FinSAC's team of experts, making it possible to go in-depth in the review of the operations, organization, outputs and effectiveness of the Supervision Department in discharging its responsibilities. At every step the Team and FinSAC's Coordinator interacted directly and extensively with the NBS Governor to report on the findings and recommendations, as well as to get "buy-in" for the reforms proposed at the highest level of the central bank. FinSAC encouraged the Governor to undertake some of the reforms proposed and, under her leadership, working groups are being set at the NBS to focus on the implementation of some of the recommendations during 2015. We made clear that further support in this area would focus on achieving positive results in the form of implementation of the proposed reforms. New areas of assistance emerged during the discussions, including a bank governance review, and information has been sent to the NBS as to what this review entails.

In many respects, given the right set of conditions - particularly unrestricted access to confidential information and supervision Staff and trust in the collaboration and soundness of the advice offered by FinSAC - the approach followed in Serbia is a very good model and prototype for the "niche" in which FinSAC can contribute most, reaching beyond the regulatory framework, while focusing on the effectiveness of how supervision is actually being discharged, an area where the FSAPs cannot reach, but it is absolutely critical.

UKRAINE

FinSAC gave a presentation to the NBU on approaches to the voluntary restructuring in the context of multi-creditor NPL work-outs. The presentation targeted the regulation and supervision team, with the aim of starting a NBU-led coordination effort amongst Ukrainian banks to resolve their portfolio of NPLs. A follow up activity has been financed by the EBRD to explain the content and possible advantages of the so called "Istanbul approach".

NBU requested further TA to help streamline bank capital requirements, to build the foundation to move towards new liquidity requirements and to help in designing a special regulatory regime for D-SIBs. This request was made in response to FinSAC's report on the topic prepared in 2013 on "Regulatory consistency assessment between NBU prudential requirements regulation and the EU's CRD IV/CRR framework". FinSAC has provided extensive comments on changes to the special regulatory regime for D-SIBs and discussed next steps for streamlining the capital requirements.

PILLAR 3: BANK RECOVERY AND RESOLUTION

ALBANIA

FinSAC supported the implementation of Bank Recovery Plans featured as prior DPL action and developed a Framework for the drafting of these plans. FinSAC also supported the authorities in the development of a policy for the identification of Domestic Systemically Important Banks and the development of a diagnostic tool.

FinSAC staff initiated the development of a strategy for the consolidation and resolution of "Savings and Credit Associations" aligned with international best practices. Although a very small subsector they merit attention due to the social cost and potential contagion effect of eventual failures among the savings associations.

MOLDOVA

A number of WB – IMF missions visited Moldova in the last quarter of 2014 due to exacerbating problems in three Moldovan Banks – BEM and Banca Sociala were put under "Special Administration" at the end of November and another commercial bank, "Unibank" in December. This put about 30% of its banking sector by assets under central bank administration.

The missions concluded by recommending a number of detailed immediate next steps to be taken by the authorities. Further immediate TA (i.e. on operational aspects of bank resolution) was requested by the NBM and the government. In the medium term, an overhaul reform of the banking sector will be required with a special focus on its governance structure, and revising and strengthening application of supervisory and resolution tools. The authorities are conducting investigations involving potential violation of laws and regulations by the managers and controlling shareholders of the three banks in distress.

SERBIA

FinSAC collaborated with the IMF on regulatory reform in the area of banking resolution and deposit insurance. The final legislation was adopted by the Serbian Parliament by the end of January, 2015. Future work providing assistance in ensuring proper implementation, including the drafting of by-laws, has already been defined with the NBS.

UKRAINE

The NBU requested assistance with the design of a Recovery and Resolution Planning framework. In the first stage, FinSAC will assist with the design of a methodology for the preparation of Recovery Plans for systemically important banks.

PILLAR 4: FINANCIAL CONSUMER PROTECTION

KOSOVO

FinSAC finalized complaints handling procedures, regulation and complaint forms, and developed a financial consumer disclosure framework. FinSAC also drafted a financial literacy article on effective interest rates and the responsibilities of guarantors for this framework. A consumer guide to mortgages was also developed. FinSAC provided comments to the Central Bank of Kosovo's mortgage regulation and default interest rate regulation and assisted the authorities with the introduction of market conduct supervision introduced into the insurance on-site supervisory process.

E. COLLABORATION WITHIN THE WB GROUP, THE EU AND AND IFIS

FinSAC works closely with WB senior staff located in Washington D.C. and Vienna. WB Headquarters-based staff join FinSAC staff on missions regularly, particularly for the CSEs where IT expertise is required. A joint mission to Georgia with the WB Center for Financial Reporting Reform (CFRR), based in Vienna, also took place. The CFRR was also an active participant and speaker during FinSAC's Conference on Credit Risk Management and Regulatory Provisioning in an International Financial Reporting Standards (IFRS) Environment in October in Vienna.

FinSAC also had meetings with the EU Commission and has regular communications with the European Banking Authority (EBA). As part of the Vienna Initiative, FinSAC and EBRD met with the EBA to advocate an urgent assessment of the confidentiality provisions of the Banking Laws our client countries. Once these provisions are assessed as equivalent to the EU by EBA, it is very likely that FinSAC client countries will be invited to participate in supervisory colleges. Results of the assessment are expected early 2015. Where relevant, EBA representatives also participate as speakers in FinSAC's conferences, workshops and seminars. FinSAC will strive to further expand its cooperation with EU institutions and other IFIs, particularly the Joint Research Center (ISPRA), the Joint Vienna Institute and the Financial Stability Institute.

FinSAC has been collaborating closely with the International Finance Corporation (IFC) and other IFIs in the area of NPL resolution. When working on NPL resolution, the WB seeks to propose a holistic package, bringing together a range of products and expertise from across the organization. Interventions were FinSAC closely cooperated with other IFIs include:

- TA to the central bank or supervisory agency to convene bank creditors to overcome the collective action problem, through a combination of FinSAC and the IFC interventions (e.g. Montenegro, Albania and more recently, Serbia and Croatia)

- Financial support to the public sector, for example through a DPL with specific NPL-related prior actions endorsed by FinSAC (e.g. Albania, Ukraine, etc.)

- Support to the financial sector through IFC investments in banks (e.g. Serbia)

- Acquisition of non-performing loans through the IFC's Debt & Asset Recovery program (e.g. Romania).

The recent reorganization of the WB Group under the Global Practices (GPs) has greatly encouraged that process, by bringing together, under the Finance & Markets GP, NPL-related experts and products from across the WB Group on areas such as secured transactions, credit information and insolvency systems. The close collaboration between FinSAC and the Finance & Markets GP (e.g. Croatia, Serbia, Ukraine) ensures that FinSAC's client countries benefit from the best knowledge solutions available in the WB Group.

Outside of the WB, FinSAC has promoted greater cooperation between IFIs active in the area of NPL resolution. The Vienna Initiative, where FinSAC participates, has provided a forum to initiate these discussions, which are now being replicated and expanded at the country level.

- In Croatia, FinSAC invited the EBRD to join a diagnostic mission to identify impediments to NPL resolution, which has already resulted in joint recommendations on the draft amendments to the insolvency law that were presented to the Croat authorities in February 2015. This will be followed by a joint report on NPL issues in Croatia, leading to closely coordinated initiatives from the EBRD and WBG.

- In Serbia, FINSAC played an active role, in collaboration with the IMF and EBRD, in devising a matrix of priorities for NPL resolution, which will be used as a framework to bring together key stakeholders working on NPL (public sector entities, such as the National Bank of Serbia, Ministries of Finance, Economy and Justice; lead IFIs such as the IMF, WBG and EBRD; and private sector actors).

- In Ukraine, the World Bank and EBRD are closely collaborating in helping the central bank promote a framework for voluntary out-of-court restructuring of distressed assets.

IV. LOOKING FORWARD TO 2015

1. ECONOMIC OUTLOOK

The ECA region is still struggling to return to robust growth following a short lived rebound after the global economic crisis of 2009. A slowdown in the pace of structural reforms, accompanied by tepid growth in the global economy and uncertainty arising from the conflict in Ukraine, continue to cloud the outlook. The weak external environment, especially slow growth in Western Europe, has dampened growth prospects in 2014 and it might persist in 2015. Western Europe continues to face sluggish demand and structural challenges, which are contributing to below target inflation. The quantitative monetary easing policy in the Eurozone and the resulting weakening of the Euro may help lift demand in the short term, including in several client countries for which the euro area is an important export destination. However, the external environment for the region is not expected to become particularly favorable in the coming years.

Remaining debt overhang and lost competitiveness in several new EU member states and Balkan countries are other factors that will continue to constrain the recovery. High levels of external debt and needs for large-scale external financing make some countries particularly vulnerable to changing conditions in international financial markets, in particular an expected rise in US interest rates. The high levels of NPLs in the region, together with the ongoing restructuring of the banking sector, are likely to continue to constrain investment and consumer demand in 2015.

At the same time, fiscal positions are slowly improving and many countries in the region are gradually regaining competiveness after wage adjustments. Projected stability in oil prices, down from the high levels in previous years, should also mitigate uncertainty among energy importers in the region. That all makes it likely that the recovery in the western part of the ECA region continues, albeit not at a fast pace. The geopolitical tensions Ukraine-Russia are likely to persist, making the economic recovery more difficult.

FinSAC's efforts to assist client countries in addressing the drag of high NPLs will continue to a critical focal point in 2015, as well as dealing with the deep banking crisis in Ukraine and Moldova.

2. FINANCIAL REGULATORY & SUPERVISORY OUTLOOK

The implementation of the ambitious EU reform agenda will continue to offer opportunities for FinSAC to assist both EU and non-EU member countries in adopting the new Directives into national legislation, drafting secondary legislation and regulations. Moreover, FinSAC's work at the micro-prudential level has been very well received by national central banks and, as we gain more experience, it will be extended to other countries, focusing on the effectiveness of supervision. The adoption of reforms and the resulting efficiency gains in this area are really important as recognized by recipient countries.

3. FINSAC'S STRATEGIC POSITIONING GOING FORWARD: NARROWER SCOPE, MORE DEPTH

FinSAC will consolidate its position as a niche player and "Center of Excellence in Banking Supervision and Resolution" with a more focused mandate to maximize impact within FinSAC's limited scale. The "niche" is in itself a broad area and one where FinSAC can expand its range of TA products offered.

To most effectively leverage Fin SAC expertise in response to the growing demand for its products, but given finite resources, the focus will be on providing targeted, specialized consulting services. FinSAC is in process of hiring at least one more senior supervisor able to support client countries in the implementation of legal, regulatory and supervisory solutions.

While FinSAC will continue to offer macroprudential and financial stability products at the specific request of a client country, its four pillar strategy will gradually transform to a largely three pillar-centric strategy focused on:

A. MICRO-PRUDENTIAL PILLAR

Work under this pillar is divided into two subthemes:

1. MICRO PRUDENTIAL SUPERVISION AND REGULATION:

A menu of different modules in the supervisory and regulatory area is offered.

The first *supervisory module* addresses the policies and procedures for determining the scope and frequency of inspections, the planning of inspections, the preparation and content of inspection reports, and the review of loan portfolios by sampling during on-site inspections. This module was successfully undertaken in Serbia (see section IV, c) assessing the efficiency and efficacy of onsite supervision practices.

Other available modules include a review of the architecture and control framework within banking supervision departments, for example:

- enhancing onsite/offsite cooperation or exploring the implementation challenges, benefits and drawbacks of integration of onsite and offsite;

- assessing supervisory approval processes, quality assurance and the governance of supervision;

- developing, or assessing, supervisory guidance and tools for preparing risk assessments of individual banks;

- developing supervisory plans; including the tailoring of supervisory procedures and expert teams to the individual institution;

- assistance with the assessment of bank's business models;

- assisting with the implementation of forward looking risk based supervision;

- assisting with the development of a remedial action and enforcement framework;

- assistance in developing quantitative tools for the crisis management and resolution process: and models for quick checks of viability and cost assessment of different resolution options

On the regulatory side, tailored assistance in the area of implementation of Basel III/CRDIV/CRR is offered. In some countries, FinSAC's TA program focusses on:

- compliance with CRD IV/CRR requirements by performing or reviewing gap analyses of the existing regulations compared to the CRD IV/CRR;

- assisting with quantitative impact assessments and providing proactive advice on action and implementation plans;

- developing country specific tailored criteria for identifying domestic systemically important banks, as required by CRD IV and Basel III;

- assisting countries with the development and calibration of the various buffers included in CRD IV and Basel III; and

- selectively targeting some of the Basel Core Principles to enhance both the regulatory and supervisory aspects, in particular bank governance, consolidation, related parties and large exposures.

For each of these modules, clients must give the FinSAC team full access to confidential inspection reports, inspection planning, risk assessments and outcomes. This access can be anonymous, as long as the nature of the individual bank is shared (state owned bank, systemically important bank, small bank, …). A relationship of trust with the client is essential and FinSAC treat all information as strictly confidential.

• Cross border banking supervision – home host issues

Almost all of FinSAC's client countries have banking systems that are dominated by foreign banks, mostly Eurozone banks. While global banks come with benefits for host countries, they also pose specific risks and challenges to host country supervisors.

FinSAC can work with client countries in the area of cross border banking supervision including; risk assessments and supervisory strategies for specific risk posed by foreign banks; and addressing home host issues and building safeguards to prevent contagion risk.

2. NON-PERFORMING LOANS

FinSAC has several ongoing programs designed to address the high NPLs and NPLs resolution. These programs overlap with micro prudential and recovery and resolution work. They have a long-term horizon and a complex configuration due to the multidimensional nature of NPLs resolution.

Indeed, high NPLs can often be explained by the interplay of many factors, including legal obstacles in collateral realization, specific requirements in tax legislation and accounting, as well as consumer protection issues and difficulties with the Court system. Even though every project and country is different, the overall approach to dealing with NPLs resolution projects generally involves two stages: a diagnostic and an implementation stage. In the diagnostic stage, a detailed analysis of the overall portfolio by slicing and dicing the exposures is performed. Generally speaking, this stage also includes a legal analysis of the use and hurdles to voluntary out of court restructuring and the efficiency of bankruptcy and court systems and an assessment of the consistency of the NPLs definitions and provisioning. During the implementation stage, the program can assist countries with voluntary guidelines for out of court restructuring and the review of legislation.

Comparability of NPLs definitions, reporting standards and provisions across countries has been a long standing concern, particularly the scope of the definitions of restructuring or forbearance with different classifications in many countries. The EBA has recently developed technical standards on supervisory reporting on forbearance and NPE to perform harmonized overall data collection on asset quality and lower costs for international banks by gradually decreasing divergent definitions. FinSAC can provide assistance with:

- benchmarking the existing NPLs identification and classification practices against international good practice while taking into account specific country circumstances and products;

- assessing and addressing the prudential interactions of IFRS implementation for banks when transitioning to IFRS. This includes policy advice on timing and safeguards when moving from deterministic regulatory provisioning models to expected loss methodologies and an assessment of the preconditions for increased reliance on IFRS[5].

B. BANK RECOVERY AND BANK RESOLUTION PILLAR

OVERVIEW

The region's banking supervision and resolution system is, in some respects, based on modern principles and recent reforms have strengthened legal frameworks (for example, through the introduction of single resolution tools such as a bridge bank). Still, in most countries the resolution of distressed banks is largely based on "early intervention" via simple conservatorship, without the power to override shareholder rights, and a liquidation system under "traditional" insolvency laws. In some countries shareholders' rights can become a major impediment for prompt decision making in the event of a crisis in failing systemic institutions without endangering financial stability and critical functions interruption (e.g., Albania). Comprehensive reform of current resolution frameworks should therefore be considered for most countries in the region. So far only Serbia has overhauled, with IMF and FinSAC assistance, its bank resolution system in January 2015, introducing a bank resolution system aligned to the BRRD.

Authorities in the region have started preliminary work on recovery and resolution plans (RRPs). So far only a few have developed binding requirements for systemically important banks and established internal best practices and tools for the assessment of recovery plans. There is, however, a general lack of powers to execute resolution plans and tools. A first key step will be to support the development of mandatory guidelines requiring (systemic) banks to adopt and submit recovery plans. Thereafter the preparation of bank-specific resolution plans and internal guidelines for early intervention and resolution are to be established.

The effective execution of a resolution regime and the powers to apply resolution tools require not only coherent legal frameworks, but also a stable institutional architecture and strong governance. The immediate and full application of the complex BRRD might not be the best tailored solution for many of the Balkan countries at this stage

Often, the optimal solution of establishing an independent administrative resolution authority may not be advisable on resource and efficiency grounds. Many smaller countries, even in the EU, have therefore decided to set up a "resolution unit" within the supervisory authority or the central bank. In those cases ensuring organizational and functional separation, while at same time establishing information sharing and coordination mechanisms will be a difficult balancing act. In this respect, it is good practice for the resolution unit to receive periodic information and to be empowered to trigger resolution independently of the supervisor.

Similarly, the application of the bail-in tool may require special consideration in transition countries. It will be challenging to ensure that those

[5] FinSAC has cooperated with the Centre for Financial Reporting Reform in this area.

who profit from risky investments also potentially take the loss in case of failure (bail-in). The lack of a developed bond market comes with the risk that unsecured creditors such as depositors will be subject to bail-in which can increase contagion risks.

The application of the "No Creditor Worse Off principle" can also become problematic in an environment where fair values are difficult to assess.

The recovery and resolution pillar comprises three subthemes:

- **Bank Recovery and resolution regulation in EU countries:**

FinSAC assists authorities in the region to strengthen their bank resolution frameworks to preserve financial stability, protect depositors, and save tax-payer resources. The EU BRRD was adopted to avoid disorderly bankruptcy and costly bail outs. It introduced a number of bank resolution instruments, such as sale of business, bridge bank, asset separation, and bail-ins, that EU authorities must comply with as a minimum. FinSAC is committed to support resolution authorities in developing strong tools and strategies to fulfill their role as part of the financial sector safety-net in application of the BRRD including covering critical home/host issues.

FinSAC also provides assistance in the development of coordination and information sharing systems, especially where the resolution authority is set up as a separate but still integral part of the supervisory authority. FinSAC can help define respective responsibilities to achieve smooth and efficient decision making and successful cooperation while maintaining operational and functional independence.

- **Resolution framework for non EU countries**

While advising authorities on the development of appropriate resolution frameworks, FinSAC is mindful of the lessons learnt elsewhere and aligns its TA with international good practice (e.g., Key attributes and IADI Principles for Effective Deposit Insurance) and local market circumstances.

The overall aim for systemic banks is to make the resolution feasible without taxpayers' support and without systemic interruption, while ensuring the critical functions of an institution remain intact. Attention is also given to ensuring an efficient least cost resolution for non-systemic banks and developing related safety nets, taking into account specific local market circumstances.

- **Resolution of specific institutions**

Home supervisors and resolution authorities are responsible for the development of recovery and resolution plans, and this has raised new challenges to cross border supervision and resolution. FinSAC can help client countries address these home host issues by providing advice on preparing for and implementing the resolution of individual institutions, thereby ensuring independent support and advice in line with international developments for dealing with financial sector distress.

Some authorities in the region have started work on recovery plans but few have developed binding requirements for the adoption of resolution plans for systemically important banks. As highlighted by international standards adopted in the wake of the financial crisis, RRPs are essential instruments for effective crisis preparedness and management. A recovery plan contains information on how a bank would try to recover from severely adverse conditions that could cause its failure by setting out in advance its "menu of options" for dealing with a range of stress events. Resolution plans are drawn up by the authorities and set out options for resolving the bank and ensuring the continuity of critical functions.

Recovery plans are likely to increase the resilience of the banking system and should allow better use and targeting of supervisory resources and powers. FinSAC can provide TA in drawing up and defining legal requirements of RRPs, and in the development of supervisory guidance for the assessment of recovery plans (for example, as regards the adequacy of qualitative and quantitative recovery indicators).

C. STREAMLINED FINANCIAL STABILITY AND MACRO-PRUDENTIAL PILLAR

- **Crisis prevention and preparedness**

In the area of crisis preparedness, FinSAC assists countries in contingency planning and tests crisis management plans using CSEs. The objective is threefold: first, to identify gaps and weaknesses in regulatory and legal frameworks; second, to assess the decision making and information sharing by the authorities to the "crisis event" and; finally, to train the authorities so they can organize regular CSEs on their own. A CSE tests information analysis and sharing, decision making, home-host cooperation, and communications within the Central Bank and between the other national financial sector authorities. The exercises are conducted in a virtual environment and can be tailored to the needs of the authorities as the scope can be set up as intra-agency, inter-agency or a combination. CSEs have now been conducted in many countries.

With initial CSEs (funded by FinSAC or from another source) now completed in many of its client countries some are asking FinSAC to repeat the exercise. A decision needs to be made about whether and how this should be undertaken. Options range from providing IT only support to the delivery of the CSE (with expenses covered by the client country), to a full repeat CSE depending on specific country circumstances (e.g., recent amendments of the resolution framework, considerable and imminent vulnerabilities of the country financial sector). There is scope to take this product line further, focusing on the cross-border aspect of crisis management, organizing multi-jurisdiction CSEs, or with the participation of multiple home- and host authorities and possibly international observers (such as the ECB and EBA).

In the macroprudential area, FinSAC will continue to selectively agree to requests from clients to assist in building quantitative tools for systemic risk assessment and in designing the institutional set-up for national financial stability arrangements.

D. OTHER FINSAC ACTIVITIES

FinSAC will continue with a flexible program of knowledge creation and dissemination activities, such as working papers and seminars, in response to the diverse and changing needs of its client countries. In 2015, a working paper assessing key lessons learnt from CSEs will be developed. A working paper analyzing the supervisory and regulatory issues encountered by prudential supervisors of host countries that have a systemic presence of foreign banks will also be produced. A conference on cyber security and an expert-to-expert workshop on recovery and resolution plans are planned. A deposit insurance conference with the BFG from Poland is also scheduled. FinSAC expect to reengage with the Georgian authorities on IFRS for the banking system and assist in setting up a Deposit Insurance Scheme, as agreed between Georgia and the EU and included in the on-going Development Policy Loan with the WB.

E. FINSAC WORK PROGRAM FOR 2015

During 2015 FinSAC's TA work will focus on:

(I) CSE: completing the CSE in two additional countries (Kosovo and Albania), to finalize these exercises in all our client countries;

(II) BRRD: FinSAC's work will expand significantly in addressing the complex issues of bank recovery and resolution and the adoption into national legislation of the BRRD. A Regional Workshop on recovery and resolution plans will take place in April;

(III) Micro-Prudential Supervision: FinSAC will continue its innovative work in micro-prudential supervision, completing the ambitious work being done in Serbia and extending this pilot to other countries in the region;

(IV) NPL Resolution: FinSAC will complete in 2015 its work in Albania addressing the restructuring of up to 30 companies with large NPLs and assisting the Bank of Albania with the off-site review and resolution of 20-25 additional companies, dealing with up to one quarter of the country's NPLs. It will expand the NPL resolution work to Serbia and Croatia in partnership with other IFIs. Finally, the work in this critical are in Ukraine will continue in 2015-16;

(V) Crisis Countries: FinSAC will continue its assistance to countries faced with systemic banking crises (Ukraine and Moldova) in cooperation with the World Bank and IMF teams preparing assistance packages;

(VI) Seminars and Working Papers: FinSAC will deliver two additional regional seminars on deposit insurance funds investment regime (jointly with the Deposit Insurance Fund of Poland) and a seminar on cyber preparedness for which a 15 country survey was conducted and a working paper is being drafted;

(VII) Deposit Insurance: FinSAC will provide assistance in Bosnia Herzegovina and Georgia in their reform efforts to adopt modern deposit insurance system compatible with EU legislation;

(VIII) Broadening Partnerships: FinSAC will strive to expand its cooperation with EU institutions, particularly the Joint Research Center (ISPRA) and other IFIs;

(IX) Broadening FinSAC's donor base: FinSAC is exploring its transformation into a multi-donor trust fund, inviting other EU countries to support the efforts from the Austrian Federal Ministry of Finance, to expand its resource base to address longer-term serious problems in the banking sector, particularly in Ukraine, where

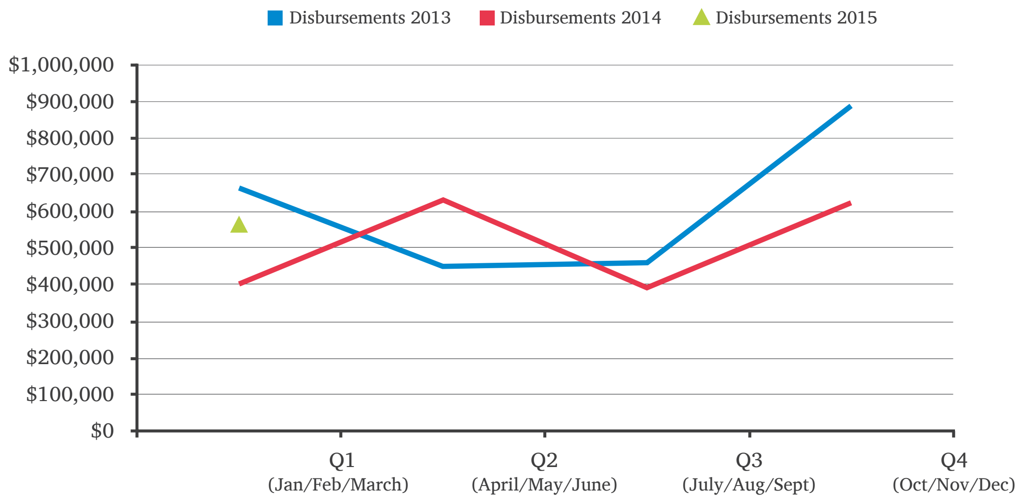
FinSAC has approach the National Bank of Poland to consider becoming a FinSAC donor. As indicated in this Annual Report, FinSAC will follow the demand for its services, responding flexibly, to request from our client countries.

F. DISBURSEMENT OF TRUST FUND BY FINSAC

Total budget disbursed: **6,964,182/US$** (as of March 31, 2015).

Current Fund available balance: **1,317,865/US$** (as of March 31, 2015).

	Disbursements 2013	Disbursements 2014	Disbursements 2015
Q1 (Jan/Feb/March)	$664,492	$404,734	$654,170
Q2 (April/May/June)	$449,979	$630,224	
Q3 (July/Aug/Sept)	$459,140	$392,733	
Q4 (Oct/Nov/Dec)	$887,714	$622,844	
Total	**$2,461,325**	**$2,050,535**	



DISBURSEMENT BY CATEGORIES:

A. FOR THE PERIOD OF 1 JUNE 2011 – 31 DECEMBER 2014

	US$	%
STAFF COSTS[6]	4,471,196.82	68.11
AIRFARE REBATE	-27,259.35	-0.42
CONSULTANT FEES[7]	992,090.07	15.11
ASSOCIATED OVERHEAD COSTS[8]	80,353.94	1.22
TRAVEL EXPENSES[9]	935,754.63	14.25
PUBLICATIONS & WORKSHOPS	112,478.97	1.71
TOTAL	**6,564,615.08**	**100.00**

[6] Incl. FinSAC Coordinator, five TTLs and one program assistant
[7] Incl. consultant firms and consultants
[8] Incl. office maintenance, utilities, cleaning services, office supplies, depreciation etc.
[9] Incl. travel expenses of both staff and consultants/visitors

B. FOR THE PERIOD OF 1 JANUARY 2014 – 31 DECEMBER 2014

	US$	%
STAFF COSTS	1,593,970.81	75.21
CONSULTANT FEES	194,326.55	9.17
ASSOCIATED OVERHEAD COSTS	29,183.06	1.38
TRAVEL EXPENSES	255,220.76	12.04
PUBLICATIONS & WORKSHOPS	46,508.32	2.27
TOTAL	**2,050,535.40**	**100.00**

DISBURSEMENT BY ACTIVITIES:

C. FOR THE PERIOD OF 1 JUNE 2011 – 31 DECEMBER 2014

	US$	%
TF010025 - general for all activities (June 2011- Febr 2013)[10]	2,710,151.77	41.28
ADMINISTRATIVE COST[11]	741,724.70	11.30
NPL	1,076,534.18	16.40
CPFL	475,402.79	7.24
BANK RECOVERY & RESOLUTION	231,470.78	3.53
CRISIS SIMULATION	649,465.17	9.89
MICROPRUDENTIAL FRAMEWORK	423,287.12	6.45
MACROPRUDENTIAL FRAMEWORK	256,578.57	3.91
TOTAL	**6,564,615.08**	**100.00**

F. FOR THE PERIOD OF 1 JANUARY 2014 – 31 DECEMBER 2014

	US$	%
ADMINISTRATIVE COST	550,997.84	26.87
NPL	358,514.08	17.48
CPFL	212,686.77	10.37
BANK RECOVERY & RESOLUTION	235,079.11	11.46
CRISIS SIMULATION	364,577.69	17.78
MICROPRUDENTIAL FRAMEWORK	289,555.69	14.12
MACROPRUDENTIAL FRAMEWORK	39,124.22	1.91
TOTAL	**2,050,535.40**	**100.00**

[10] Between June 2001 and February 2013, the Trust Fund had no separate windows. The window labelled "TF010025 - general for all activities" was used for all types of categories and activities allowed under the TF. Starting from February 2013, the following windows were created: Administrative & Monitoring, NPL, BRR, CPFL, Micro & Macroprudential.

[11] Incl. cost of all types of categories not related to the particular topical activities namely: management, webdesigner, program assistant cost, translations services, utilities, office maintenance, office supplies, depreciation, publications and representation cost.

ATTACHMENT: RESULTS FRAMEWORK TABLE

MICRO-PRUDENTIAL FRAMEWORK

	FinSAC Activities / Inputs	FinSAC Outputs	FINSAC Output Indicators	Expected Client Outcomes	Potential Client Outcome Indicators
SERBIA: ASSESSMENT OF ON-SITE EXAMINATION PRACTICES	Review and benchmarking of onsite examination practices: scope of inspections, planning of inspections, inspection reports, sampling of the loan portfolio, examination preparation and tools to decrease the workload of the onsite inspection division, coordination on & off site.	Proposals to improve the efficiency and effectiveness of onsite examination practices (report to the NBS Sr. management and Governor)	Proposals discussed and endorsed by the Governor & Senior Management of the NBS. Working Groups established to foster implementation of recommendations. Client satisfied with proposed solutions and decision matrix.	Performing more effective, risk based and efficient onsite bank examinations. Better use of scarce supervisory resources. More risk based supervision. Improved governance, accountability and risk management in financial institutions. Better supervised and more resilient banking system.	Improved level of compliance with Basel Core Principles for Effective Banking Supervision" assessed by IMF-World Bank FSAP teams. More precise and comprehensive assessment of risks across the banking system. A lower incidence of failure of supervised institutions due to earlier and more effective intervention.
SERBIA: STRUCTURING THE PILLAR 2 DIALOGUE	Review and benchmarking of SREP/Pillar 2 practices: ICAAP/SREP as a supervisory tool, risks to be included in the ICAAP, calculation of capital requirements, stress tests, available capital, capital adequacy and other issues.	Proposals to improve the efficiency of the supervisory review and examination process (SREP dialogue – Pillar 2)	Proposals discussed and endorsed by Governor & Senior Management of the NBS. Client satisfied with proposed solutions and committed to implementation.	Improved skills and better understanding of ICAAP and SREP. Better use of scarce supervisory resources. More risk based supervision. Improved governance, accountability and risk management in financial institutions. Better supervised and more resilient banking system.	Improved level of compliance with Basel Core Principles for Effective Banking Supervision" assessed by IMF-World Bank FSAP teams. More precise and comprehensive assessment of risks across the banking system. A lower incidence of failure of supervised institutions due to earlier and more effective intervention.

MICRO-PRUDENTIAL FRAMEWORK

	FinSAC Activities / Inputs	FinSAC Outputs	FINSAC Output Indicators	Expected Client Outcomes	Potential Client Outcome Indicators
SERBIA: ASSESSMENT OF ONSITE EXAMINATION PRACTICES FOR AML/CFT	Review and benchmarking of the onsite examination Practices : scope of inspections, inspection planning, inspection reports, onsite examination procedures, focused on AML activities.	Supplementary report on AML/CFT supervision. Proposals to improve the efficiency of onsite AML examination practices.	Proposals discussed and endorsed by the Governor & Senior Management of the NBS. Client satisfied with proposed solutions and committed to implementation.	Performing more effective, risk based and efficient onsite AML examinations. Better use of scarce supervisory resources More risk based supervision Improved governance, accountability and risk management in financial institutions. Better supervised and more resilient banking system.	Improved level of compliance with Basel Core Principles for Effective Banking Supervision" and FATF Principles assessed by IMF-World Bank FSAP teams. Improved compliance with international AML/CFT good practice, reflected in better scores in international assessments.
GEORGIA: PRUDENTIAL INTERACTIONS OF IFRS IMPLEMENTATION	Make assessment of impact of IFRS transition on the prudential regulation and supervision of the banking system.	Report making recommendations on ways to address the implications, the pace and timing of IFRS transition for the banking system.	Proposals discussed and endorsed by the Senior Management of the NBG. Client satisfied with proposed solutions.	More resilient and stable banking system. Prudent solutions to address the impact of IFRS on bank regulatory capital and supervision.	Improved level of compliance with Basel Core Principles for Effective Banking Supervision" assessed by IMF-World Bank FSAP teams. Improvement in the preconditions for effective banking supervision.
UKRAINE: COMPLIANCE WITH CRDIV/CRR	Prepare a gap analysis comparing the current capital and liquidity regulations with the requirements of CRDIV/CRR.	Report identifying major gaps, making recommendations for addressing them.	Proposals discussed and endorsed by the Senior Management of the NBU. Client satisfied with proposed solutions and committed to implementation.	Compliance with internationally agreed capital and liquidity rules. Better capitalized and more liquid banking system.	Improved level of compliance with Basel Core Principles for Effective Banking Supervision" assessed by IMF-World Bank FSAP teams.

NON-PERFORMING LOAN RESOLUTION

	FinSAC Activities / Inputs	FinSAC Outputs	FinSAC Output Indicators	Expected Client Outcomes	Potential Client Outcome Indicators
		GENERAL			
MONTENEGRO NPL	Supported the drafting of the "Framework for resolving non-performing loans on a voluntary basis" (Podgorica Approach) Organized two-day workshop introducing the Podgorica approach.	Provide technical assistance for the resolution of non-performing loans. Conduct diagnostic on NPL situation in countries across the Balkans.	Number of deliverables produced.	Improvement in recognition and provisioning of non-performing loans.	Improved legal environment for NPL resolution and more broadly for "doing business".
CROATIA NPL	Provided input and recommendations to the Ministry of Justice on the draft amendments to the insolvency law. Conducted diagnostic mission, along with the EBRD, on key impediments to NPL resolution in Croatia (report to be shared with the Croat authorities in 2015).	Identify key impediments (legal, regulatory, structural, economic, etc.) to the resolution of NPLs and prepare and prioritize key recommendations for policy and regulatory changes. Assess local insolvency legislation and regulatory framework against EU directives and international best practice	Average client satisfaction as measured by client satisfaction surveys. Average client satisfaction as measured by client satisfaction surveys.	Increase in write-offs of "stale" NPLs with low prospects of recovery. Increase in the number of viable Corporate obligors successfully restructured.	Reduction in the overall size of NPLs. Increase in new lending to the Corporate sector.
ALBANIA NPL	Supported the Bank of Albania (BOA) in developing standards for voluntary out-of-court restructurings. Organized hands on expert workshops with BOA and private sector banks to promote multi-creditor workouts. Provide expert input and third-party consultant support for operational and financial restructuring of large, complex defaulted Corporates.	Work with public and private sector partners to improve cooperation and collaboration in the area of NPL resolution, in particular for large, multi-creditor default situations. Develop and deliver hands on expert workshops for banking sector supervisors and private sector insolvency practitioners to improve skills and expertise in restructuring NPLs.	Average client satisfaction as measured by client satisfaction surveys.	Adopted amendments to the insolvency legal regime. Increase in the number of viable Corporate obligors successfully restructured.	Reduction in the overall size of NPLs.

NON-PERFORMING LOAN RESOLUTION

	FinSAC Activities / Inputs	FinSAC Outputs	FINSAC Output Indicators	Expected Client Outcomes	Potential Client Outcome Indicators
SERBIA NPL	In collaboration with other IFIs, developed inter-agency matrix of priorities for NPL resolution, and agreed on area of responsibilities between IFIs and relevant public sector authorities.	Collaborate with other IFIs and private sector stakeholders within the context of the Vienna initiative to develop a regional approach for tackling high levels of NPLs across Central and South Central Europe.	Average client satisfaction as measured by client satisfaction surveys.	Increase in the number of viable Corporate obligors successfully restructured	Reduction in the overall size of NPLs.
UKRAINE NPL	Provided input to the National Bank of Ukraine on improving cooperation between banks in NPL resolution; project continuing in 2015, expected to result in draft Law on Financial Debt Restructuring. Draft law on private bailiffs.	Organize and host workshops to improve cooperation, raise awareness and share knowledge amongst key stakeholders.	Average client satisfaction as measured by client satisfaction surveys.		

MACRO-PRUDENTIAL FRAMEWORK

	FinSAC Activities / Inputs	FinSAC Outputs	FINSAC Output Indicators	Expected Client Outcomes	Potential Client Outcome Indicators
BOSNIA-HERZEGOVINA MACRO-PRUDENTIAL CAPACITY BUILDING: CREDIT RISK MODELING	Work together with CBBH staff to build a credit risk model for their stress-testing framework (with a consultant from the JVI).	Background Note on Modeling Credit Risk for Stress Testing in Bosnia-Herzegovina. Excel and EViews files. Training for CBBH staff on operating the model.	Successful adaptation of analytical tools to the client's environment and needs; reflected in client satisfaction.	Enhanced analytical capacity of the macro-prudential authority, via new regular internal reports on systemic risk launched within the central bank, based on the output of newly built analytical models.	Usage of new analytical tools in internal reports and in FSR.
BOSNIA-HERZEGOVINA MACRO-PRUDENTIAL CAPACITY BUILDING: EARLY WARNING SYSTEM	Work together with CBBH staff to build a simple, quantitative Early Warning System for the Bosnian banking sector.	Background Note on Banking Sector EWS for Bosnia-Herzegovina. Excel and EViews files. Training for CBBH staff on operating the model.	Successful adaptation of analytical tools to the client's environment and needs; reflected in client satisfaction	Enhanced analytical capacity of the macro-prudential authority, via new regular internal reports on systemic risk launched within the central bank, based on the output of newly built analytical models.	Usage of new analytical tools in internal reports and in FSR.
BOSNIA-HERZEGOVINA MACRO-PRUDENTIAL CAPACITY BUILDING: CREDIT GROWTH FORECASTING UPDATE	Update the credit growth-forecasting model of the CBBH (with a consultant from the University of Amsterdam).	Short note on the model update. Excel and EViews files. Consultations (over the phone) with CBBH staff on the update.	Successful adaptation of analytical tools to the client's environment and needs; reflected in client satisfaction.	Enhanced analytical capacity of the macro-prudential authority, via new regular internal reports on systemic risk launched within the central bank, based on the output of newly built analytical models.	Usage of new analytical tools in internal reports and in FSR.

CRISIS SIMULATION

	FinSAC Activities / Inputs	FinSAC Outputs	FINSAC OUTPUT INDICATORS	EXPECTED CLIENT OUTCOMES	POTENTIAL CLIENT OUTCOME INDICATORS
MOLDOVA CSE	Conduct CSE with senior policymakers	CSE Report	Turnout: 30 + participants, including CB Governor, Minister of Finance, Head of Deposit Insurance. Endorsement of CSE Report by main client (CB)	Strengthened crisis preparedness, better coordination among stakeholder authorities	Better cooperation between authorities in the process of using public funds for bank resolution
MACEDONIA CSE	Conduct CSE with senior policymakers	CSE Report	Turnout: 30 + participants, including CB Governor, MoF Senior Advisor, Head of Deposit Insurance. Endorsement of CSE Report by main client (CB)	Strengthened crisis preparedness, better coordination among stakeholder authorities	Client better prepared to manage renewed contagion from Greece
ARMENIA CSE	Conduct CSE with senior policymakers	CSE Report	Turnout: 30 + participants, including CB Deputy Governor, MoF Senior Official (former Minister), Head of Deposit Insurance. Endorsement of CSE Report by main client (CB).	Strengthened crisis preparedness, better coordination among stakeholder authorities.	Client better able to handle contagion from Russian Rouble crisis at end-2014.

BANK RECOVERY & RESOLUTION

	FinSAC Activities / Inputs	FinSAC Outputs	FINSAC Output Indicators	Expected Client Outcomes	Potential Client Outcome Indicators
ALBANIA	Assessment of local law for resolving banks against international best practice (esp. Key Attributes and the BRRD. Analysis of existing triggers and powers for early, timely and firm intervention in failing institutions without requiring public support;. Identification of systemically important banks.	Guidelines for recovery plans List of systemically important banks	Analysis on Savings and Cooperation Association consolidation and transfer to Deposit Insurance Agency.	Adoption of mandatory recovery plan guidance. Submission of recovery plans by 7 banks. New law on Savings and Cooperative Association?. New Memorandum of Understanding (MoU) with ECB under SSM.	Consolidation and inclusion of the Savings and Cooperation Association sector under Deposit Insurance Agency. Enhanced recovery and possible future resolution planning. Increased co-ordination with cross-border parent banks home supervisor, avoiding insular national responses. Part compliance with the Financial Stability Board's "Key Attributes of Effective Resolution Regimes for Financial Institutions".
SERBIA	Assessment of local law on resolving banks against international best practice (esp. Key Attributes and the BRRD) including the role of Deposit Insurance Agencys. Support in drafting legal requirements for revised Banking Recovery and Resolution Law including effects on deposit insurance, company law etc.	Mission in cooperation with IMF (sept. 2014). Support the preparation of agreement to and implementation of MoUs between the principal authorities - Guidance note on the structural and organizational separation between resolution and supervisory tasks within one institution (NBS).	Assessment on R&R reform in Serbia (focus on use of Deposit Insurance Agency). Guidance note on separation of powers between resolution and supervision Unit in Serbia (NBS).	Adoption of overhaul new legislative framework by national parliament in January 2015 (R&R plus Deposit Insurance Agency).	Bank failures are managed in an orderly, avoiding systemic crisis; Enhanced Deposit Insurance Agency regime (funding, pay-out, etc.. in line with new EU Directive). Domestic banks covered by recovery & resolution plan. Increased co-ordination with cross-border parent banks home supervisor avoiding insular national responses.; Compliance with the Financial Stability Board's "Key Attributes of Effective Resolution Regimes for Financial Institutions". Alignment with the BRRD.

BANK RECOVERY & RESOLUTION

	FinSAC ACTIVITIES / INPUTS	FinSAC OUTPUTS	FINSAC OUTPUT INDICATORS	EXPECTED CLIENT OUTCOMES	POTENTIAL CLIENT OUTCOME INDICATORS
MOLDOVA	Assessment of local law on resolving banks against international best practice (esp. KA and the BRRD) including the role of DIA. Assistance in the preparation of the closing of 3 banks in Moldova.	Tailored country specific “decision tree” on resolution stages and powers. Gap analysis of local laws (ongoing).	Mission in December 2014. Note on Banking Sector Developments. Decision tree.	3 banks were put under special administration by the Central Bank in Q4 2014. In early stage of internal planning in overall reform of the recovery and resolution regime.	Minimizing effects of banking crisis (fraudulent scheme) on financial stability and taxpayers’ support.

BANK RECOVERY & RESOLUTION

	FinSAC Activities / Inputs	FinSAC Outputs	FinSAC Output Indicators	Expected Client Outcomes	Potential Client Outcome Indicators
CPFL TA IMPLEMENTATION PROGRAM KOSOVO	To assess the existing financial consumer protection framework by reviewing laws, regulations and practices in Kosovo compared to international good practices. To provide recommendations on ways to strengthen the level of financial consumer protection in Kosovo. The objective of this phase is to ensure that financial consumers are able to reap benefits from an expedited execution of the proposed measures.	TA to support amendments to the legal and regulatory framework as well as institutional strengthening of the financial consumer protection regime in Kosovo, including • Conducting a diagnostic review for consumer protection and Financial literacy • Preparation of strategy for CPFL in Kosovo • Preparation of Action Plan for Implementation of CPFL Strategy • Preparation of Technical Note on measures to strengthen the legal and regulatory framework for financial consumer protection • Drafting of MOU between Ministry of Trade and Industry and CBK • Provision of technical advise on Market Conduct Reporting Form • Drafting of provisions of Consumer protection for the Draft Mortgage Regulation, Draft Law on Micro Finance, Draft Regulation on Default Interest rates.	CBK satisfied with the TA support provided. CBK to approve and implement the framework	- MOU signed between Ministry of Trade and Industry and CBK - Enactment of CBK Regulation on Disclosure Requirements - Enactment of Complaints Regulation - Enactment of CBK Internal Procedure on Complaints Handling	Number of newly enacted financial consumer protection laws, regulations, guidelines and procedures: 3 Coordination mechanisms established with public sector authorities /private sector/civil society: MOU signed between Ministry of Trade and Industry and CBK on coordination and cooperation Strengthening of regulatory units for consumer protection supervision, organizational reforms to enhance capacity for financial consumer protection: Strengthened regulatory and supervisory role and capacity of CBK in financial consumer protection in particular related to disclosure requirements and complaints handling.

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