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FINANCIAL SECTOR ADVISORY CENTER

ANNUAL REPORT 2019

WORLD BANK GROUP
Finance, Competitiveness & Innovation

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WORLD BANK GROUP
Finance, Competitiveness & Innovation

Federal Ministry
Republic of Austria
Finance

ABBREVIATIONS

BRRD	Bank Recovery and Resolution Directive
CRD	Capital Requirements Directive
CRR	Capital Requirements Regulation
ECA	Eastern Europe and Central Asia region
EU	European Union
FinSAC	Financial Sector Advisory Center, World Bank
IFRS	International Financial Reporting Standards
IMF	International Monetary Fund
NPL	Non-Performing Loans
SREP	Supervisory Review and Evaluation Process

CONTENTS

Alfonso Garcia Mora
Global Director
Finance, Competitiveness & Innovation Global Practice
The World Bank

Welcome to the World Bank Financial Sector Advisory Center (FinSAC) 2019 annual report. Conceived in the wake of the global financial crisis, the Center aims to support countries in the Eastern Europe and Central Asia (ECA) region to strengthen their banking systems and address potential threats to financial stability by providing technical assistance. Reform can be challenging and requires sustained political will and commitment, often competing with other national demands. Countries in the ECA region have come a long way in stabilizing their banking sectors, strengthening financial sector laws and regulations, upgrading supervision, and enhancing bank resolution frameworks and this annual report records further encouraging progress in 2019. FinSAC has enabled the World Bank Group to provide hands-on support to client countries across ECA in this work. This will become even more important as countries face the economic and financial sector impact of the COVID-19 pandemic, which comes with new challenges for financial stability in the region. FinSAC stands ready to continue its support in the face of evolving client country demand, and it is grateful to its donors and supporters for helping it achieve this. I hope you will find this report provides a good summary of a busy year for FinSAC and highlights its role in helping support economies to grow on solid foundations and increase public confidence in the banking system.

Harald Waiglein
Director-General
Economic, Policy, Financial Markets, and Customs Duties Federal Ministry of Finance of the Republic of Austria

In our deeply interconnected region, it is clearly in all of our interests for countries to achieve and maintain strong and stable banking systems that can withstand financial shocks. One way in which Austria contributes towards this is by financing FinSAC. We are pleased to see the progress that FinSAC has helped support over recent years, from enhanced crisis management arrangements, through the establishment of well-functioning deposit insurance schemes, to the inception of recovery planning and tools to support the resolution of failing banks without use of public money. FinSAC has established a strong team and has built a solid reputation with its clients that enables them to work together with confidence. The greater emphasis on evaluation and monitoring is helping FinSAC to better demonstrate its impact and encourage further efforts to make progress. As we all seek to improve financial stability we are proud to support FinSAC in sharing its expertise and providing hands-on reform knowledge.

SECTION 1: INTRODUCTION

The World Bank Financial Sector Advisory Center (FinSAC) supports European Union (EU) neighborhood countries to improve the stability and resilience of their financial sectors.

FinSAC is a technical center of the World Bank's Finance, Competitiveness and Innovation Global Practice. Its specialist team assists client countries in the ECA region in their efforts to establish more resilient financial systems. Funded by the Austrian Government in support of its regional neighbors, FinSAC provides direct targeted assistance and policy advice as requested by governments, central banks, financial regulators, etc. The core FinSAC team's location in Vienna encourages close cooperation with clients, with easy access for regular visits.

In line with its wider brief as a knowledge center, FinSAC aims to act as a bridge. Disseminating and explaining recent relevant international policy and best practices that it helps to implement in client countries through its bilateral technical assistance projects; and advocating for client countries with the wider international community to help ensure that issues they face are recognized. This work includes research of specific themes and producing material and hosting events to help develop and share knowledge.

PROGRESS AND PITFALLS

In its nine years of operation, FinSAC has contributed to important advances in financial stability in client countries by supporting legal, regulatory, supervisory, and institutional reforms on a broad range of financial stability-related topics. FinSAC's emphasis has been on providing client countries with practical and implementable solutions for their complex financial stability challenges. Most client countries have maintained clear focus over the years but in others there has been more flux. All client countries have made concrete first steps, such as revised legislation and improved institutional arrangements for prudential supervision and bank resolution functions, but these can take time to become fully operational. Moreover, ensuring sufficient coordination and collaboration among different functions, for example through recently established coordinating financial stability committees, remains a work in progress. As reform efforts progress, so more consideration needs to be given to the complex interactions among macroprudential supervision, microprudential supervision, and bank resolution. This must ensure that, during both normal and crisis times, the objectives and tools used to promote one policy do not compromise the others. FinSAC support develops and flexes to take account of changing needs. It encourages an increasingly joined up approach. This includes using programmatic technical assistance to work with clients in a coordinated way across different areas.

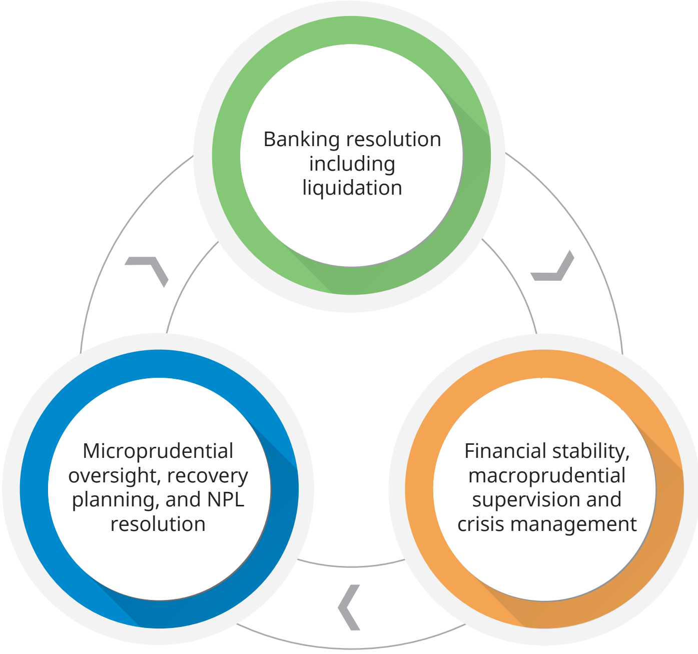
HIGHLIGHTS OF 2019

FinSAC completed thirteen projects during 2019 of which nine were direct technical assistance to client countries. Cyber security continued to be a key theme, FinSAC advised on appropriate local regulation in two countries, and tested preparedness to deal with a cyber crisis in one of them. Effective schemes of deposit insurance are an important feature of a modern financial safety net that help build public confidence in financial systems. Client countries also demonstrated strong interest in recovery planning. Non-performing loans (NPL) continue to be a legacy issue in many client countries. In addition to direct assistance, FinSAC produced a policy paper this year to provide insights into NPL write-off practices in the ECA region and more widely. This includes potential policy actions to reduce the outstanding stock of NPLs. This paper was one of four knowledge products completed during 2019, which included another two analytical papers and a FinSAC-hosted international conference about financial technology (fintech) for regulators and central bankers. Two further seminars were organized as part of the technical assistance within specific projects. FinSAC also continued to provide extensive support on bank resolution, covering legal and regulatory reforms and capacity development for newly established bank resolution departments. An additional fifteen projects are ongoing into 2020; five knowledge products and ten technical assistance projects (one funded by the EU) of which four address several themes within a broader programmatic mandate. Further details of all FinSAC activities completed in 2019 and ongoing into 2020 are included in Sections 4 and 5 of this report.

EXPENDITURE

FinSAC committed a total of € 3,060,923 to its activities in 2019. This was an increase of 10.8% compared to 2018. The increase reflects a further expansion of FinSAC's work program and team (as 2019 was the first complete year with FinSAC's expanded team in place). Work related to macroprudential policy and crisis management accounted for 21% of total expenditure, work on microprudential frameworks and NPL resolution for 26%, and work on bank resolution for 19%. Work on programmatic projects (that combine two or more of these areas) represented 16% of total expenditure, and administrative expenditure accounted for the remaining 18%.

FinSAC areas of focus

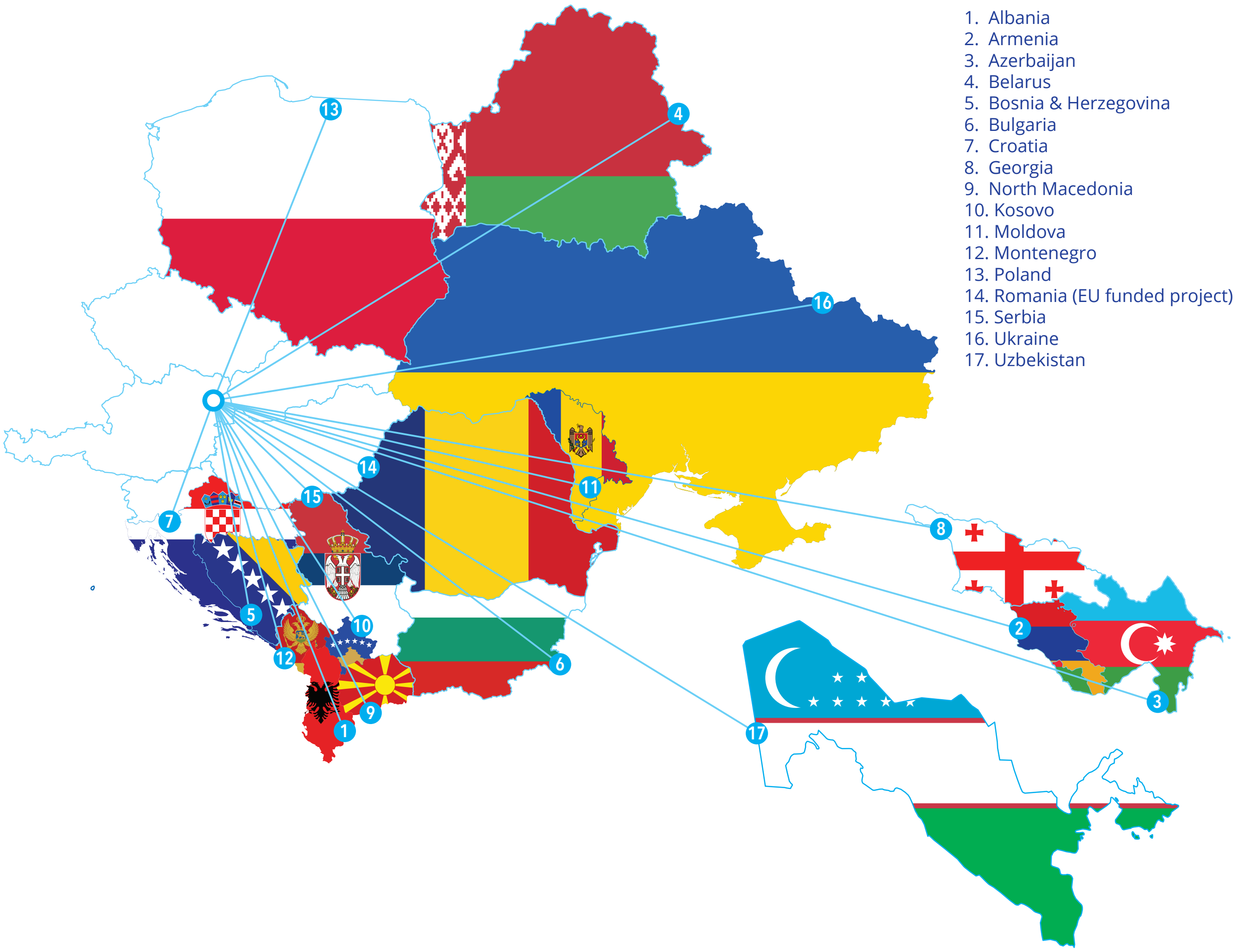


SECTION 2: FINSAC: WHAT IT IS AND WHAT IT DOES

SUPPORTING CLIENT COUNTRIES BUILD MORE RESILIENT AND STABLE FINANCIAL SECTORS

FinSAC was created in 2011 in response to the global financial crisis to assist countries in emerging Europe identify issues and problems in national banking sectors and recommend tailored solutions. Since then it has become a well-established and trusted advisor on the adoption of new and upgraded legal, regulatory, and supervisory frameworks. Financial sector stability is a precondition for the financial system to fulfil its potential in supporting economic development and is therefore critical in achieving the World Bank Group's twin goals of reducing poverty and fostering shared prosperity. This has a special resonance for the ECA region, which was the World Bank region worst affected by the global financial crisis and where many countries experienced prolonged periods of lackluster financial sector performance and subdued economic growth.

BASED IN VIENNA, CLOSE TO CLIENT COUNTRIES IN ECA



1. Albania
2. Armenia
3. Azerbaijan
4. Belarus
5. Bosnia & Herzegovina
6. Bulgaria
7. Croatia
8. Georgia
9. North Macedonia
10. Kosovo
11. Moldova
12. Montenegro
13. Poland
14. Romania (EU funded project)
15. Serbia
16. Ukraine
17. Uzbekistan

FINANCIAL SECTOR SPECIALISTS WITH ACCESS TO BROADER WORLD BANK EXPERTISE

FinSAC has built an in-house team of experienced financial sector specialists focused on providing the tailored know-how on a core curriculum of financial stability topics needed by client countries that are at different stages of financial sector reform. FinSAC is part of the World Bank's Finance, Competitiveness and Innovation Global Practice, which identifies the promotion of financial depth and stability in developing countries as one of its three major global mandates, together with financial inclusion and finance for development.

Miquel Dijkman
Lead Financial Specialist,
FinSAC Coordinator
Macroprudential supervision,
crisis management

Aquiles Almansi
Lead Financial Specialist
Cyber security and crisis management

Juan Ortiz
Senior Financial Sector Specialist
Microprudential supervision

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Senior Financial Sector Specialist
Bank recovery & resolution

Karlis Bauze
Senior Financial Sector Specialist
Non-performing loans

Nurgul Irsalieva
Program Assistant
Administrative support, trust fund
administration, procurement and
budgeting, event management

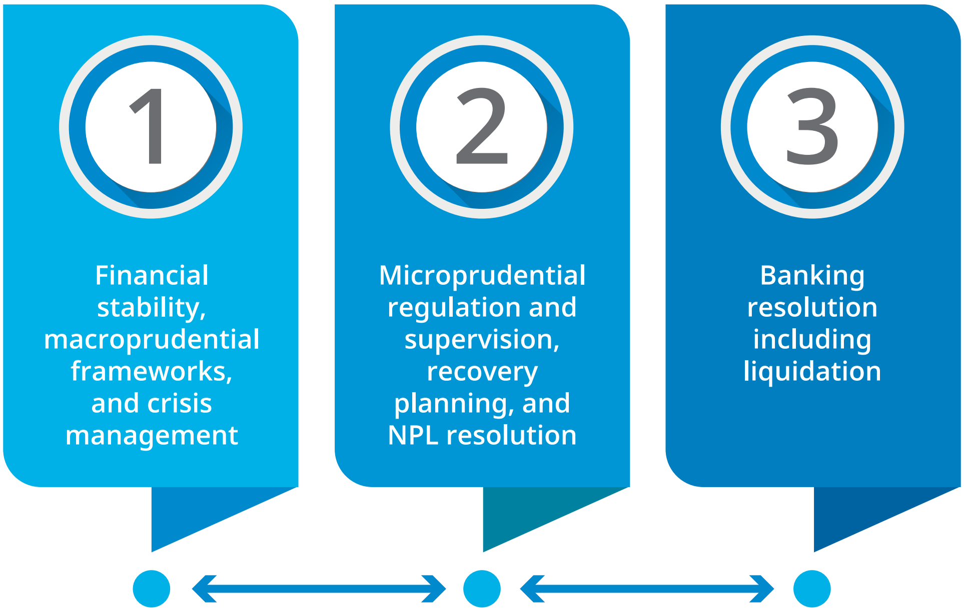
Ismael Ahmad Fontán
Senior Financial Sector Specialist
Supervisory and regulatory affairs

Milica Nikolic
Financial Sector Specialist

Nan Zhou
Financial Sector Analyst

OFFERING TARGETED BILATERAL TECHNICAL ASSISTANCE

Technical assistance is provided within the areas described in the following three pillars:

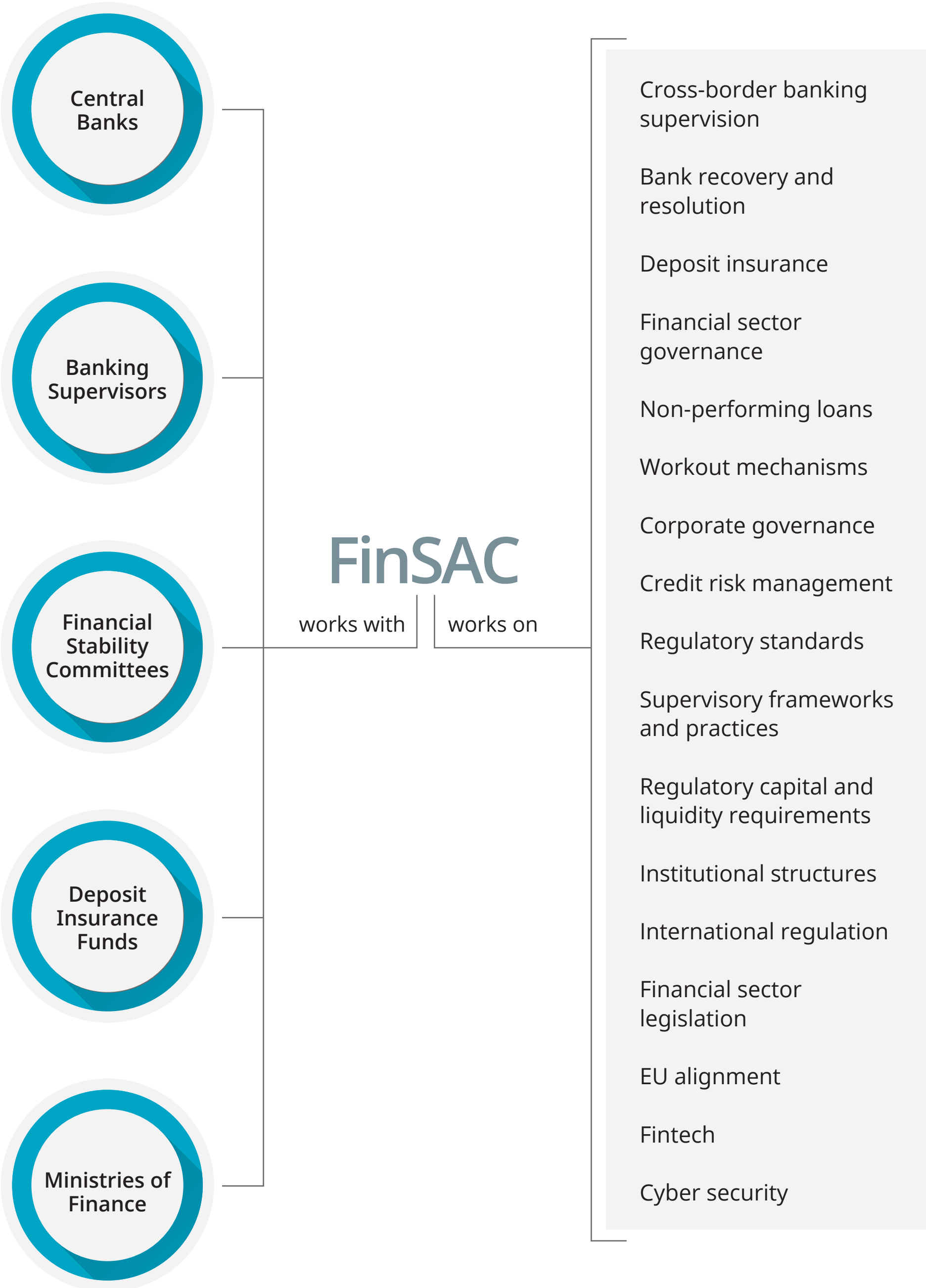


The range of assistance offered by FinSAC has grown and evolved over the years. Since its inception, FinSAC has supported its client base through three distinct channels: (a) client-specific technical assistance assignments; (b) technical workshops, conferences, and seminars, and (c) regional research projects with corresponding outreach activities. Through these activities, and within its programmatic focus, FinSAC has aimed to become a leading regional "knowledge center". Thematically, FinSAC's work is centered around three pillars. The first pillar focuses on macroprudential supervision and crisis management, the second on microprudential oversight and NPL management, the third on bank recovery and resolution.

Client countries have benefitted from help to revise national laws, strengthen legislative frameworks, and take account of international standards and good practice. Other projects assist with revising bank resolution frameworks, strengthening the financial sector safety net, supporting the implementation of recovery planning for banks, helping train supervisors and regulators, identifying concrete steps to address NPL problems, or testing crisis preparedness.

FUNDED BY THE AUSTRIAN MINISTRY OF FINANCE

As part of their strategic outreach to help support regional financial stability, the Austrian Federal Ministry of Finance fully funds FinSAC and implementation of its program through a Trust Fund.


Central Banks
Banking Supervisors
Financial Stability Committees
Deposit Insurance Funds
Ministries of Finance
FinSAC
works with
works on
Cross-border banking supervision
Bank recovery and resolution
Deposit insurance
Financial sector governance
Non-performing loans
Workout mechanisms
Corporate governance
Credit risk management
Regulatory standards
Supervisory frameworks and practices
Regulatory capital and liquidity requirements
Institutional structures
International regulation
Financial sector legislation
EU alignment
Fintech
Cyber security

SECTION 3: THE REGIONAL ECONOMIC ENVIRONMENT AND FINANCIAL SECTOR PRIORITIES

THE EUROPEAN UNION

The European economy has weakened over the past year. Europe experienced a sharp slowdown in external demand on the backdrop of rising trade tensions. Uncertainty about policies led corporates to postpone investments, and reconsider global value chains in view of weakened multilateral cooperation. Consequently, demand for investment goods, which thrives on trade integration, slowed, affecting particularly the manufacturing sector in export-oriented countries. The subdued outlook for growth and inflation prompted the European Central Bank to implement another round of easing measures in September 2019. In global financial markets, monetary easing in advanced economies has led to a further reduction in bond yields.

Amidst a weakening economic outlook, credit expanded at a moderate pace. Banks focused increasingly on riskier sectors, such as commercial real estate and consumer credit, to generate a yield in an environment of low interest rates and shrinking margins. This, combined with a slowing economy, also affected bank profitability with competition from non-bank financial entities and fintech firms adding further pressure. In a bid to boost profitability, EU banks continued their efforts to streamline operational expenditure. In this process, many EU banks established inhouse fintech incubators/accelerators or set up partnerships with fintech firms. Asset quality continued to improve, although at a slower pace. By mid-2019, the NPL ratio stood at 3.0%, down from 3.6% the year before. This is the best outcome since EU Member States harmonized NPL definitions in 2014. Although NPLs remain unevenly distributed within the EU, some of the most significant declines were reported in countries facing the highest NPL ratios, particularly in Cyprus, Greece, Portugal, Slovenia, and Italy. Strengthening asset quality, favorable funding conditions, and narrowing sovereign spreads helped to dissuade concerns about the sovereign-bank nexus, but the exposure of financial entities to government debt instruments remained high in several countries.

Although the overall amount of losses from operational risk was on a downward trend, operational risk continued to be an area of considerable concern for EU banks. Cyber attacks and data breaches represented a serious challenge for banks, with the increasing sophistication of technology in banking and payment services requiring significant investments in the management of information and communications technology systems and data protection. In addition, various money laundering and terrorism financing scandals received widespread public attention, highlighting banks' efforts to build expertise and awareness and to strengthen internal controls.

> By mid-2019, the NPL ratio stood at 3.0%, down from 3.6% the year before

In an effort to complete the banking union, additional technical work was undertaken to establish a roadmap for the introduction of a common European Deposit Insurance Scheme, which has been labelled the "missing leg" of the banking union. But a lack of consensus about possible preconditions, including the introduction of non-zero risk weights on government debt, have prevented further progress. Meanwhile, Bulgaria and Croatia strengthened technical cooperation with the European Central Bank with a view to participation in the banking union.

Banks in Europe continued apace with the issuance of debt instruments that can be converted to equity if a bank incurs losses that cause a capital shortfall. In 2019, European banks issued about €100 billion of new "bail-in" debt, mostly in the form of senior

non-preferred bonds. Issuance of senior non-preferred bonds has increased consistently since their introduction in 2016, as additional European countries pass the necessary legislation, allowing more banks to tap the market. The low interest environment in the eurozone has created favorable conditions for banks to sell senior non-preferred bonds to investors looking for higher yields. Nonetheless, the widespread issuance of these bonds could increase banks' debt servicing costs, considering that senior non-preferred bonds typically trade at a significant risk premium vis-à-vis conventional instruments.

Some banking pressures emerged in Italy and Germany. In Italy, Banca Carige continued to experience difficulties. After failing to raise €400 million in capital, the European Central Bank appointed three temporary administrators and a surveillance committee to replace Banca Carige's board of directors. Rather than pushing the distressed bank towards resolution or liquidation, a depositor protection fund financed by Italian banks funded the bulk of the bank's €700 million capital increase in exchange for an 80% stake. In addition, Banca Popolare di Bari, a cooperative bank and largest lender in the south of Italy, was put under special administration by the Bank of Italy. The bank was kept afloat with public resources. The government set up a development bank, provided it with €900 million, and let it fund the restructuring of the distressed bank together with an interbank fund. These experiences illustrate the difficulties in imposing losses on investors in a bank in an environment where retail investors hold a significant amount of these liabilities. In Germany, NordLB received a green light from the EU competition authority for €2.8 billion in capital injections and €5 billion in guarantees following significant losses on the bank's portfolio of shipping loans. The financial burden was split between two German provinces that own the bank and publicly owned savings banks after negotiations with private equity firms over a stake in the bank faltered.

WESTERN BALKANS

Growth in the Western Balkans slowed down to 3.2% in 2019. Activity decelerated in several economies, with marked weakness stemming from slowing investment (Kosovo), manufacturing (Serbia), and export growth (Albania). One-off factors related to weather and subsequent energy production dampened activity in Albania, while domestic demand softened in Montenegro. The slowing momentum in approximation with the EU, after the initiation of membership talks with Albania and North Macedonia were blocked, affected investor sentiment and the broader growth outlook. Lending to households, particularly unsecured consumer lending, accounted for much of the credit growth, while lending to non-financial corporates was more uneven.

> Financial sector reform continued to be focused on efforts to align with EU frameworks

In most countries, NPL ratios continued their downward trend reflecting dividends from past reforms on legal, regulatory, and tax impediments, write-offs, and modest volumes of NPL sales, including the first large NPL transaction involving a foreign party in Albania. The most significant improvements took place in Serbia and Albania. The Bank of Albania approved in July a regulation on the out-of-court treatment of distressed borrowers by banks (also known as the Tirana Approach) and shortened the timeframe for a mandatory write-off to two years after being classified as a loss. Through write-offs banks have by and large significantly reduced their exposure to problem assets, but there are serious unresolved challenges related to overindebted, mostly corporate borrowers, whose financial condition continues to be weak as the write-off usually

does not benefit the debtor. The absence of a comprehensive corporate restructuring program, aimed at liquidating non-viable companies and restoring the commercial viability of overindebted but potentially viable ones, raises important questions about the sustainability of the reduction in NPL ratios.

Banks in the region remained generally well-capitalized and liquid, but there were a few cases of non-systemic bank failures. After placing two small banks with a combined market share of 6% under administration in 2018 over capital shortfalls, the Central Bank of Montenegro proceeded to revoke the banking licenses of the two troubled lenders and pay out guaranteed deposits.

Ownership structures in banking sectors, which historically have been dominated by eurozone-based parent banks, continued to evolve. Parent banks sold local subsidiaries in Albania, North Macedonia, and Serbia to rapidly expanding regional lenders, and in some cases to domestic investors. This reflected the continuing need to rebuild capital and liquidity buffers at the parent bank levels, as well as the application of 100% risk weights to the sovereign exposures of EU banks' non-investment grade third countries, including the Western Balkans. These developments placed a heavy premium on bank licensing practices, including shareholder transparency and qualitative assessments of the viability of prospective owners' business plans.

As was the case in previous years, financial sector reform continued to be focused on efforts to align with EU frameworks, notably the Capital Requirements Directive (CRD) IV, the Capital Requirements Regulation (CRR) as well as the Bank Recovery and Resolution Directive (BRRD). The main challenges included meeting the Basel III liquidity requirements, which require banks to maintain pools of high-quality liquid assets, as well as the issuance of bail-in debt in less developed financial markets. Countries also continued their transition towards expected credit loss models, which became mandatory in 2018, focusing on capacity development and data challenges.

EU NEIGHBORING REGIONS – BELARUS, MOLDOVA, AND UKRAINE

Despite a moderate economic slowdown, driven by weakening or subdued growth in major trading partners such as the eurozone and Russia, economic conditions in the EU neighboring countries remained broadly favorable. Economic growth was underpinned by strong credit growth, particularly to households, while the favorable economic tide helped to address legacy issues in the financial sector, notably high volumes of NPLs and a high degree of dollarization in the banking system.

Credit growth to households buoyed consumption in Belarus, but the state-dominated banking sector remained heavily exposed to state-owned enterprises. The financial condition of state-owned companies combined with the use of state-owned banks as a tool for economic policymaking under directed lending programs were key drivers affecting asset quality in the banking sector. Pressures on asset quality were particularly visible in the portfolio of restructured corporate debt. Despite active measures, including the differentiation of prudential policies to reflect the higher risk of foreign-currency denominated lending and deposits, the financial system remained highly dollarized.

In Moldova, wide-ranging efforts to improve shareholder transparency continued apace. These efforts, together with time-bound plans for the reduction of banks' related party exposures, set the stage for the sale of stakes in several banks that were affected by the so-called raider attacks in which illicit schemes were used to gain control over banking assets. The National Bank of Moldova also lifted the intensive supervision regime for the country's largest bank.

The favorable economic tide helped address financial sector legacy issues

The reforms and the strong liquidity position of the banking sector contributed to a recovery in credit growth. The credit recovery helped to decrease the share of NPLs in the total loan portfolio, although the reported NPL ratio remained comparatively high.

NPL reduction also remained a key priority for Ukraine, with a spike in the NPL ratio in the aftermath of the 2014 banking crisis. The crisis led to the liquidation of more than ninety banks, nationalization of the largest bank in the country, and left a persistent legacy in the form of high NPLs. For the first time in years, the NPL ratio dropped below 50% in 2019. Although the banking sector returned to profitability and most NPLs were adequately fully provisioned for, state-owned banks, representing more than half of the banking system, struggled to remove NPLs from their balance sheets. A protracted legal battle about the nationalization of Privat Bank between its former owner and the National Bank of Ukraine continued in 2019. In the aftermath of the nationalization, the Ukrainian government initiated litigation in numerous jurisdictions, including in the United States and the United Kingdom, to recover assets it alleges were stolen by its previous owners.

SOUTH CAUCASUS AND UZBEKISTAN

Azerbaijan continued to recover from the banking crisis and recession caused by a prolonged decline in oil prices since mid-2014. Although the strengthening economy had a positive effect on the banking sector, pervasive dollarization, unhedged foreign exchange positions, and high NPL volumes continued to weigh heavily on financial sector performance. In an effort to address high NPLs, the authorities required banks to restructure foreign exchange-denominated retail loans, including through a redenomination to the domestic currency, extension of maturities, extension of interest rates, and write-off of overdue interest rates and fees. However, in the absence of a more holistic approach including an out-of-court settlement system for corporate loans, prospects for a decisive resolution of problem loans remained weak.

Armenia and Georgia experienced rapid credit growth against the backdrop of robust economic growth. Favorable economic conditions enabled banks to rebuild capital buffers, lower NPLs, and strengthen profitability. Despite encouraging developments in recent years, dollarization continued to present a considerable challenge, leaving the banking sector vulnerable to systemic liquidity shocks and foreign-currency induced credit risk. The National Bank of Georgia tightened lending standards aimed at bringing down credit growth to more sustainable levels.

Credit also expanded rapidly in Uzbekistan's state-dominated banking sector. With state banks accounting for about 85% of the banking system's assets, the banks' main function was to support the government's investment and development plan by extending credit, with the government providing directives, funding, capital, and guarantees as needed. While reported bank soundness indicators looked reassuring, rapid credit growth led to increasingly tight liquidity conditions. In addition, several large unhedged state-owned corporate borrowers suspended servicing some of their foreign exchange-denominated credits, raising important questions about the economic significance of officially reported asset quality indicators.

SECTION 4: TECHNICAL ASSISTANCE IN 2019

1

Financial stability, macroprudential frameworks, and crisis management

PILLAR 1

FinSAC technical assistance within pillar 1 aims to assist countries in building capacity and the institutional frameworks for monitoring and timely mitigation of threats to financial stability and to bolster their readiness to respond to episodes of instability. It has done so by providing hands-on support to financial stability departments responsible for macroprudential supervision, and the development of interagency cooperation arrangements for safeguarding financial stability, typically in the form of financial stability committees. It continues to undertake technical work to strengthen the financial sector safety net, particularly support to deposit insurance agencies. It has organized numerous crisis simulation exercises, allowing responsible authorities to test their readiness to face financial instability in a simulated environment. Over the years, many FinSAC client countries have seized the opportunity to test their crisis management arrangements, with scenarios that involve cyber incidents as triggers for broader instability increasingly popular.

FINSAC PROJECTS COMPLETED IN 2019

BELARUS: ASSESSMENT OF CYBER SECURITY REGULATIONS FOR THE FINANCIAL SECTOR

The National Bank of Belarus asked FinSAC to compare their cyber security regulations with the texts in FinSAC's Digest of Cyber Security Regulations and Guidance (a compilation of the regulations and guidance issued by national jurisdictions and international organizations related to cyber security since 2004) to identify potentially different approaches to the matters they regulate or issues they had not yet addressed. The FinSAC analysis focused on Standard 34.101.41, which deals with cyber security regulations for Belarusian banks, and Operational and Analytical Center Order 64, which regulates all information systems in the country. Using natural language processing techniques, the analysis identified the twenty-five texts in the Digest closest to the Belarusian regulations and then compared each of their thousands of sentences with those of the national ones. A challenging aspect of the analysis was comparing Standard 34.101.41, partially worded as guidance, with the mandatory nature of Order 64 and most international regulations. The findings and corresponding recommendations were transmitted to the authorities for further action.

GEORGIA: CYBER CRISIS SIMULATION EXERCISE

FinSAC delivered a first cyber security crisis simulation exercise at the National Bank of Georgia in 2017. The focus then was on managing cyber incidents and attacks on systemic banks and on critical financial infrastructure such as payment settlement systems. To assess progress since 2017, the National Bank of Georgia requested a second cyber crisis simulation exercise. This was delivered by FinSAC in September 2019 and included the support of a senior member of the World Bank's Information Security Team. While standard simulations typically deal with the traditional consequences of any shock on the reputation, liquidity, and solvency of financial institutions, cyber simulations focus on incident response and not necessarily the effects. As in the 2017 exercise, high-ranking representatives of all Georgian banks accepted the National Bank's invitation to participate in this new simulation. The banks' representatives role-played the management teams of three institutions subject to cyber incidents, interacting with the Board and the Supervision and Banking Operations Departments of the National Bank, and also CERT.GOV.GE that operates under the Data

Exchange Agency of the Ministry of Justice and is responsible for handling critical incidents that occur within Georgian governmental networks and critical infrastructure. A confidential report to the National Bank authorities presented FinSAC analysis of the exercise and corresponding recommendations.

KOSOVO: IMPROVING CRISIS MANAGEMENT AND STRENGTHENING THE DEPOSIT INSURANCE FUND

FinSAC carried out multiple activities as part of this technical assistance project to bolster Kosovo's readiness to manage a financial crisis. FinSAC provided hands-on technical support for the establishment of a revamped financial stability committee consisting of the Central Bank of Kosovo, Ministry of Finance, and Deposit Insurance Fund of Kosovo. FinSAC worked closely with the authorities on a detailed set of terms of reference for the new committee and fostered consensus on a new memorandum of understanding, on which basis the committee was established in December 2019. FinSAC spearheaded revision of the information-sharing mechanism between the Central Bank and the Deposit Insurance Fund. It also facilitated agreement on a bilateral memorandum, signed in January 2020, giving the Deposit Insurance Fund improved access to depositor data to help them better respond to ongoing developments in the banking system as needed and provide prompt compensation in a bank failure that involves a pay-out.

At a technical level, FinSAC assisted the Central Bank and Deposit Insurance Fund in several specialized areas. For the Central Bank, FinSAC revised the set of internal regulations and procedures for emergency liquidity assistance to enhance the Central Bank's operational readiness when faced with liquidity-distressed banks. The work was undertaken with the active participation of various Central Bank departments, including banking supervision, monetary policy, legal, and financial stability to ensure that the operational framework was well understood and could be put to use quickly in times of need.

> "The technical assistance was extremely hands-on, results based, and delivered a framework that works because it takes into account the local context."
>
> **Shkëndije Himaj**
> Coordinator for General Functions
> Central Bank of the Republic of Kosovo

FinSAC produced a communication strategy with the Communication Department to guide Central Bank outreach and coordination vis-à-vis other financial safety net stakeholders in a crisis, including updating the Rule on Communication and Protocol and setting out the principles for public communication during financial crises. FinSAC prepared a crisis binder for Central Bank staff, which serves as a handy toolkit to support their timely and decisive response at different stages of episodes of financial instability.

For the Deposit Insurance Fund, FinSAC advised on the formulation of a funding policy document with an analytical underpinning for resource projections. This was adopted in December, enabling the Fund to deliberate well in advance the economic and financial implications of policy scenarios and take early measures to ensure its sustainability. Although the intention was originally for FinSAC only to conduct a review of premium calculations this task was broadened into the development of a funding policy, which was completed and endorsed by the Fund's Board. FinSAC will continue to support the Fund in strengthening its capacity to conduct verifications of bank-reported data on insured deposits, which is critical to ensure accuracy in the contributions charged to banks, with a new project in 2020.

SERBIA: STRENGTHENING THE FOUNDATIONS AND ANALYTICAL BASIS FOR THE DEPOSIT INSURANCE SYSTEM

FinSAC technical assistance to the Serbian Deposit Insurance Agency to strengthen the foundations and analytical basis for the deposit insurance system was successfully completed in 2019. FinSAC assisted with an assessment of the Serbian deposit insurance system against the International Association of Deposit Insurers Core Principles in 2018 and helped develop the action plan to address identified weaknesses and inform necessary legal changes. During 2019, the authorities drafted amendments to the Deposit Insurance Law establishing the legal basis for lowering the level of the relatively high deposit insurance contributions. These were adopted by the National Assembly of the Republic of Serbia in October 2019. FinSAC assisted with development of a target fund size model for the Serbian Deposit Insurance Agency completed in 2019. The model was developed in collaboration with the United States Federal Deposit Insurance Corporation and calibrated to the Serbian context, with the results incorporated in the amended law. FinSAC supported in-depth training for the staff of the Deposit Insurance Agency on the model. In addition, the 2015 memorandum of understanding between the Deposit Insurance Agency and the National Bank of Serbia was updated to enhance information sharing on banks' risk profiles and resolution plans.

PROJECTS ONGOING INTO 2020

ALBANIA: DEPOSIT INSURANCE STRENGTHENING

FinSAC initiated this technical assistance project to the Albanian Deposit Insurance Agency in December 2019 to support their reform and strengthening of existing arrangements for depositor protection. The project involves quantitative evaluations of the coverage levels for customer deposits at banks and savings and credit associations in Albania, and the ex-ante fund size target for ensuring coverage for failures of several non-systemic banks. The assessments are expected to inform the Deposit Insurance Agency's medium-term strategic planning and facilitate knowledge transfer in these areas. In collaboration with Deposit Insurance Agency staff, FinSAC began evaluating the deposit coverage levels against international standards and in light of Albania's prevailing economic and social conditions. Hypothetical scenarios under various increments of coverage increase are being analyzed with a balanced view between their economic benefits to depositors and their cost implications for financial institutions and the Deposit Insurance Agency. FinSAC also started the methodological groundwork for target fund size analysis, coordinating with the Bank of Albania and the Deposit Insurance Agency to tailor a stress test model to the legal framework for bank resolution and the scope of available information.

GEORGIA: ASSESSMENT OF NEW CYBER SECURITY REGULATIONS FOR THE FINANCIAL SECTOR

The National Bank of Georgia requested assistance from FinSAC to compare their regulations with the texts listed in the FinSAC Digest of Cyber Security Regulations and Guidance. FinSAC studied two orders of the National Bank of Georgia on information security. The twenty-five texts in the Digest closest to the Georgian regulations were identified and a comparison made. FinSAC reported the findings and made recommendations on several matters, including the corporate governance of cyber risk and the dimensions of a bank's risk profile that its risk management framework should take into account. The project will be finalized in 2020.

GEORGIA: STRENGTHENING THE DEPOSIT INSURANCE AGENCY

In 2019, FinSAC continued its assistance to the Deposit Insurance Agency and other public stakeholders in Georgia towards improving the financial

safety net, building on a previous FinSAC project in 2016-2018. The focus of this phase is to strengthen the institutional capacity of the recently established Deposit Insurance Agency, including strengthening its payout procedures and capacity and establishing the foundation for future development of the deposit insurance system in line with international best practice and the EU legal framework. Following the launch of the project in April 2019, two missions visited Tbilisi, focusing on: (i) developing an efficient deposit insurance payout system and procedures; (ii) exploring policy decisions on the crisis management and the contingent financing frameworks; (iii) providing inputs to the Deposit Insurance Agency's draft strategic plan 2020-2023; and (iv) providing in-house training to Deposit Insurance Agency staff including on deposit payouts, risk analysis, strategy planning, and contingency financing. The strategic plan will be discussed during a Deposit Insurance Agency Supervisory Board meeting in early 2020 and will also serve to prepare the annual work plan. Work will continue in 2020 on the development of the deposit insurance payout procedures. A software vendor is finalizing the development of the Deposit Insurance Agency's management information system in support of the deposits payout, which will significantly strengthen payout capability.

FINSAC SUPPORT FOR INCREASED CYBER RISK PREPAREDNESS–SPECIAL FEATURE

Supporting efforts to strengthen financial stability is the core mission of FinSAC. As Boards and Chief Risk Officers of banks and other financial institutions become increasingly concerned about cyber risk, FinSAC has responded by helping client countries' authorities and senior management prepare to manage cyber incidents and by advising on cyber security regulations for financial institutions.

FinSAC has been delivering crisis simulation exercises for financial sector authorities since its inception. In recent years, the scenarios have increasingly included cyber incidents affecting the liquidity and solvency of financial institutions, demanding the usual decisions from the authorities to stabilize the financial system. Observing the limited familiarity of many participants with cyber risk management, FinSAC undertook a survey on cyber preparedness among central banks in 2015. Following up on the survey's findings, FinSAC began offering simulation exercises focused exclusively on the handling of cyber incidents. Addressing incident response has encouraged some authorities to invite the participation of market players in their simulation exercises, thus delivering more realistic and informative interactions.

FinSAC has sought to enhance the technical complexity of its cyber crisis simulation exercises in cooperation with the World Bank's Information Security Team and develop new simulation tools. This provides opportunities for authorities and senior management to practice interacting with their technical information security staff during cyber incidents. That practice should help to overcome the informational and linguistic gaps typically present among individuals of radically different professional backgrounds. The technicians could face, for example, the problem of identifying suspicious behavior inside an institution's network. The findings and the required business continuity decisions would have to be appropriately communicated to senior management and the decisions implemented. The results of those decisions could lead to a sequence of meaningful interactions among the participants. Complementing the exercises focusing on communication and coordination, FinSAC can develop

computer simulations illustrating the many possible consequences of alternative decisions during the incident response process. The wealth of experiences recorded during the many simulations already executed, plus technical contributions by the World Bank's Information Security Team, provide a handy training tool for authorities and senior management of financial institutions to learn the possible consequences of their incident-response decisions.

The other strand of FinSAC's cyber security focus is on appropriate regulations. Cyber risk management in the financial sector is a universal theme and global regulatory bodies have issued guidance and advice that is widely relevant. To help update client countries on these different proposals and to discern which might be the most appropriate for them to implement, in 2017 FinSAC developed a Digest of Cyber Security Regulations and Supervision (available on the FinSAC website) outlining the different existing and proposed regulations on cyber risk management in the financial sector in leading jurisdictions and highlighting relevant legal/regulatory issues. The Digest is one of FinSAC's most frequently downloaded publications (over 260 times, in different editions, during 2019). It is regularly updated to keep track of the growing body of literature published by national financial sector authorities and international organizations.

A sub-product of the Digest was the production of a paper that is posted on the World Bank's website identifying the critical topics typically addressed by cyber security regulations and guidance.[1] This outlines attempts to identify the emerging consensus on practices to implement regulations, as well as on how to supervise their implementation by individual financial institutions. By early 2020 this paper had been downloaded 3751 times around the world, including 1180 times from countries in Europe and Central Asia.

The Digest has also enabled mapping of individual national regulations to relevant literature. This mapping compares each sentence with the hundreds of thousands in related texts of the Digest. That comparison makes it possible to identify material conceptual differences and omissions that deserve the attention of the national authorities. Given the large volume of texts involved, FinSAC has employed natural language processing techniques to analyze and extract features of raw text. The Digest will continue to be regularly updated and it should be possible to improve these techniques to monitor the evolution of the Digest's content and to map national regulations to it and to apply deep learning and other machine learning tools.

1 (http://documents.worldbank.org/curated/en/686891519282121021/Financial-sector-s-cybersecurity-regulations-and-supervision)

2

Microprudential regulation and supervision, recovery planning, and NPL resolution

PILLAR 2

FinSAC technical assistance within pillar 2 aims to support client countries in strengthening prudential regulation in line with international standards established after the global financial crisis, and in developing effective enforcement through forward-looking, risk-based supervision in banking systems often dominated by foreign, especially European, banks. FinSAC has advised on policies and procedures within banking supervision departments, including for example onsite/offsite cooperation, supervisory plans, the development of remedial action and enforcement frameworks, and quantitative tools for assessing risk profiles of banks. FinSAC has helped countries to establish a more robust supervisory function by targeting specific areas, such as governance, licensing, related party lending, and large exposures. Additionally, FinSAC has provided extensive support to banking supervision departments on evaluating banks' recovery plans, that identify credible options to survive a range of severe but plausible stressed scenarios.

FinSAC has also supported client countries in their efforts to reduce NPLs, which despite encouraging trends continue to be a drag on banking sector and broader economic performance in some jurisdictions. FinSAC has continued to support countries tackle high levels of NPLs, offering detailed knowledge and technical expertise in, for example, early warning systems of NPL recognition; the application of recent prudential regulation (European and international) on NPL identification; accounting and prudential aspects of NPL provisioning; tools and strategies for NPL resolution; available options for internal and external NPL management, including asset management companies; and aspects of corporate governance arrangements for NPL resolution.

FINSAC PROJECTS COMPLETED IN 2019

MONTENEGRO: BANKING STABILITY AND FINANCIAL SECTOR LEGAL FRAMEWORK

FinSAC technical assistance to the Central Bank of Montenegro completed in 2019 helped strengthen the banking legal and regulatory framework. FinSAC reviewed and provided feedback on draft legislation aligning the banking laws in Montenegro with relevant EU Banking Directives including CRD IV, BRRD, and the Deposit Guarantee Schemes Directive. The FinSAC review of the (i) Credit Institutions Law, (ii) Law on Resolution of Credit Institutions and Law Amending Bank Bankruptcy and Liquidation Law, and (iii) Deposit Protection Law were further shared by the authorities with the European Commission to facilitate its review of the draft laws. The banking laws were passed in December 2019 and are expected to further strengthen the financial safety net and the banking sector regulatory and supervisory framework in line with the EU Directives. FinSAC also supported the drafting of secondary legislation and relevant guidelines and manuals. It contributed to the drafting of the Decision on the Minimum Standards for Management of Credit Risk, amended by the Central Bank in December 2018 (No. 86/2018) and July 2019 (No.42/2019). This will help to harmonize the recognition of problem assets with applicable European standards, and further align regulation on credit risk management with good practices and European Banking Authority guidelines. Additionally,

a seminar was organized for the Central Bank on NPL resolution with a focus on collateral valuation in June 2019. Taken together, the reforms undertaken with FinSAC support helped to strengthen the legal and regulatory basis for banking supervision and resolution, and for narrowing the gap between the standards applied by the regional banks operating in Montenegro and domestically owned and non-systemic banks.

SERBIA: CORPORATE INDEBTEDNESS AND PREVENTION OF NPLS

Serbia has made encouraging progress in NPL reduction through a working group established in 2015 (comprising the Ministry of Finance, National Bank of Serbia, Ministry of Justice, World Bank, International Monetary Fund, European Bank for Reconstruction and Development, and other local authorities). The working group developed an NPL resolution strategy and initiated a series of enhancements to regulatory frameworks, including the regulatory treatment of restructured receivables, improvements in collateral valuation, development of a database for real estate collateral valuations, identification and removal of impediments for the development of the NPL market, and judicial and legal reforms. It is now implementing the second phase of the NPL strategy and accompanying action plan for the period 2018-2020. One area of focus is the early identification and monitoring of NPL volume, strengthening the capacity of the Ministry of Finance and the National Bank to act pre-emptively and providing a basis for the creation of an early warning system. In this context, the authorities expressed an interest in developing a better understanding of the financial position of the largest borrowers in the system. In 2019, FinSAC, in cooperation with KPMG Belgrade, conducted a study on corporate indebtedness and prevention of NPLs in the Serbian real sector. The study explored the effectiveness of previous loan restructurings by banks and companies' financial viability. It covered the period from 2014-2018 and included almost 60% of Serbian corporates, measured by revenue. KPMG and FinSAC experts presented the study and discussed its results with the working group in November. Among other findings, the study identified that while the NPL ratio decreased substantially in the financial system over the period, the financial health of corporates showed only limited signs of improvement. As a follow-up of this study, the working group is planning to prepare a framework for the timely identification and efficient restructuring of NPLs, which is planned for 2020.

> "The support and guidance of FinSAC consultants in determining the main goals and approach was extremely useful, helping hone our focus on issues that matter."
>
> **Ognjen Popovic**
> Senior Business Analyst
> Serbian Ministry of Finance

UKRAINE: IMPROVING THE QUALITY OF BANKING REGULATION IN LINE WITH THE EU FRAMEWORK

FinSAC began working with the National Bank of Ukraine on this project in 2016. It aimed to bring the bank regulatory regime in line with the European CRD IV/CRR framework and Basel Standards. The project focused on updating the regulatory framework on capital definition and establishing new short term and long-term liquidity ratios consistent with Basel III. At the time of completion, this project had assisted the National Bank in introducing capital regulation instruments with write-down/conversion

mechanisms; development of the main part of a regulation regarding the calculation of the regulatory capital on consolidated basis; finalization of a draft on the calculation of regulatory capital on solo basis; drafting of a new regulation on capital adequacy requirements for operational risks that will be implemented once relevant amendments to the Banking Law are adopted; development and implementation of a liquidity coverage ratio; and development of a methodology setting the requirements for calculating a net stable funding ratio that was approved by the National Bank Board. Activities initiated under this project continue under a programmatic project in Ukraine (see pages 39-40) that is taking forward development of requirements on the leverage ratio, risk weight assets calculation for credit risks under the Basel standardized approach, large exposures limits, and finalizing drafts on capital charge for market risks and the regulatory capital on consolidated basis.

UZBEKISTAN: NEW BANKING LAW AND GUIDED BASEL CORE PRINCIPLES SELF-ASSESSMENT – SPECIAL FEATURE

In October 2019, Uzbekistan's Senate approved a package of financial sector laws, including a new Banking Law. The new Banking Law represents an important milestone. Its approval concludes a year of intensive technical cooperation between FinSAC and the Central Bank of Uzbekistan's banking supervision department. The new Banking Law marks the beginning of a new chapter for banking in Uzbekistan.

Economic reforms started in 2017, with the alignment of the informal and official exchange rate and the start of market-oriented reforms in the state-bank dominated financial sector. State banks' core business was to channel funds from public sector entities to priority sectors and firms, mostly state-owned enterprises, often at preferential terms. The priority for banking regulation and supervision was to ensure compliance with government-dictated policy priorities, rather than the preservation of financial stability and the protection of depositors.

It soon became apparent that the legal framework underpinning the Central Bank's oversight of the banking sector was in dire need of reform. The Central Bank invited the World Bank to review an initial draft that was undergoing Cabinet discussion. The review identified several important weaknesses. The World Bank offered assistance in drafting a new law, to support an orderly transformation and sound development of the financial sector. The Central Bank accepted the offer and withdrew the old draft. Work on the new law, under a new project funded and staffed by FinSAC, started in October 2018.

Over the following six months, the Central Bank and FinSAC completely redrafted every article of the new law. Technical discussions helped onboard the Supervision Department to international best practices for banking supervision and sensitize the Central Bank to the new challenges associated with the transition from a state-dominated banking sector to one with a more prominent role for private investors.

One of the key challenges was to establish a robust "gatekeeper function", giving the Central Bank sufficient powers to ensure that: private investors seeking to enter the banking sector meet common fit and proper standards; de facto ownership structures are well-understood and monitored continuously; and related party lending is contained. Throughout the former Soviet Union, in countries such as Ukraine, Russia, Azerbaijan, and Kazakhstan, weaknesses in this gatekeeper function bred non-transparent ownership structures, enabling the emergence of oligarchic banking that ultimately set the stage for costly financial crises.

Another priority was to legally allow the Central Bank to exercise supervisory judgment in fulfilling its mandate in the face of dynamically evolving banking risks. This was a drastic and sometimes controversial change from the old legal framework that prioritized compliance checks with administrative requirements over the mitigation of risks. Banking supervision also needed to be shielded from political and industry pressures, and Central Bank supervisors needed better legal protection while discharging their duties in good faith. If Central Bank decisions are challenged, courts should defer to the Central Bank's discretion in making complex supervisory decisions, and these should only be reversed in exceptional cases.

While these concepts have broad international acceptance, they represented a radical paradigm shift for Uzbekistan. The government used to view banks as any other commercial enterprise, and reform focused on addressing corruption and red tape by limiting inspection powers and discretion of state agencies. An important element of this project was FinSAC's outreach to explain the importance of treating banks differently. The team participated in stakeholder events with bankers, lawmakers, ministries, other public authorities, and the media, including TV interviews. This engagement helped to address concerns and set the stage for the passage of the new law, eventually approved in October 2019. Amendments did take place during the approval process, but the final version upholds the fundamental concepts and principles that the project team sought to establish and now provides a reference for the region. It lays the foundation for an effective banking supervision function, supports an orderly transformation of the banking sector to a more market-oriented environment, and upholds the key principles that the team sought to establish.

The new Banking Law has had a galvanizing effect on financial sector reform in the country. Following its passage, FinSAC assisted the authorities in undertaking a self-assessment against the Basel Core Principles for Effective Banking Supervision, concluded in November 2019. The assessment identified a variety of shortcomings, highlighting the need to undertake reforms on a broad range of areas in an environment of considerable capacity constraints. It also helped the Central Bank's Banking Supervisory Department better understand international best practice. FinSAC discussed the outcomes of the assessment in detail with Central Bank senior management, who also endorsed a supervisory action plan that sequences and prioritizes reform for the next three years. FinSAC will continue its support to help address the most pressing gaps.

PROJECTS ONGOING INTO 2020

MOLDOVA: BANK RECOVERY AND SUPERVISION

FinSAC has worked closely with the Supervision Department of the National Bank of Moldova in advancing its current recovery planning framework. In early 2019, FinSAC provided the National Bank with draft guidelines for recovery plan assessment as well as tools for supervisors that could contribute to more harmonized assessments. Later in the year, FinSAC held a comprehensive two-day workshop for all employees in the Supervision Department responsible for recovery plan assessments. This was followed by hands-on assistance to the authorities in the assessment of recovery plans that banks submitted in 2019. Based on the work undertaken so far, the new methodology will be implemented and used for recovery plan assessments in 2020. This project will continue in 2020 as the focus moves to evaluating operational procedures related to recovery planning.

3

Banking resolution including liquidation

PILLAR 3

FinSAC technical assistance within pillar 3 focuses on strengthening national frameworks to deal with failing banks. This includes supporting the adoption of modern resolution tools in line with international good practice. In the wake of the global financial crisis, there has been a concerted effort to ensure that countries are better prepared to deal with future bank failures through the introduction of enhanced intervention powers in the pre-insolvency stage, new statutory tools to allocate losses to shareholders and creditors, upgrading the capacity of dedicated bank resolution departments, and the preparation of bank-specific resolution plans. FinSAC can guide clients in how they can best adopt and adapt their frameworks to align with international and EU standards: the Financial Stability Board's Key Attributes of Effective Resolution and the EU's BRRD.

FinSAC can also help authorities understand the resolution tools and options available to them and work with them to ensure that these tools can be applied successfully if needed.

FINSAC PROJECTS COMPLETED IN 2019

MOLDOVA: BANK RESOLUTION FRAMEWORK

With FinSAC support, Moldova has been making demonstrable progress in establishing a more robust bank resolution framework. FinSAC continued to work productively on bank resolution with the National Bank of Moldova in 2019 to better tailor the bank resolution framework to the specificities of the Moldovan financial system. FinSAC assistance to the National Bank consisted of three mutually reinforcing modules. The first component was the development of the methodology for calculating risk-based ex-ante contributions to the resolution fund. FinSAC analyzed the draft regulation prepared by the National Bank and provided recommendations based on the EU approach but also taking into consideration local context and legislation. The National Bank initiated an open discussion on the methodology and the feedback is being addressed by National Bank management. As a follow up to this work, the National Bank has started the process of amending the Law on Bank Recovery and Resolution to increase the feasibility of bank resolution.

> "The materials provided by the FinSAC experts were very detailed and qualitative, with various approaches and examples that contributed to understanding. The FinSAC team showed solid knowledge and responded to all new requests during the technical assistance."
>
> **Mrs. Natalia Triboi**
> Deputy Head, Banking Resolution Division
> National Bank of Moldova

It will include relevant elements of the EU BRRD, tailored to take into consideration the level of development of the Moldovan banking system and its private debt markets. Work on the draft law will continue in 2020.

The second component consisted of a comprehensive study on the feasibility of implementing a minimum requirement for own funds and eligible liabilities in the Republic of Moldova. The study examined several different possible approaches, and the potential effects of each approach on Moldovan banks. The National Bank are using the study to inform its decision-making process about the best way to implement minimum requirements. Finally, the FinSAC team assisted the National Bank in developing a regulation laying out the rules on bailing-in derivative contracts. There will be further work on this under a follow-up project in 2020.

PROJECTS ONGOING INTO 2020

ROMANIA: RESOLUTION SIMULATION EXERCISE

Building on a successful first resolution simulation exercise in Romania in 2018, FinSAC developed, organized, and delivered a second exercise in November 2019 that focused on the application of specific resolution powers. This project is funded by the EU Structural Reform Support Service. Over 70 representatives of Romania's financial safety net took part in the exercise including from the National Bank, the Bank Deposit Guarantee Fund, the Ministry of Public Finance, and the Financial Supervisory Authority. EU representatives, from the Structural Reform Support Service, the Directorate-General for Competition, and the European Banking Authority, participated as observers. To build a sense of realism, teams worked from their actual work premises communicating via a web-based mail exchange created for the exercise. They used supporting infrastructure and analysis, such as the public interest test and restructuring plans, as they would in a real-life scenario. A detailed first draft report analyzing the actions and decisions taken during the exercise was shared with the Romanian authorities in December and will be finalized in close cooperation with the participating teams in early 2020. This exercise was a further demonstration of the Romanian authorities' readiness to use a reflective process to further improve their crisis management framework. The National Bank's Resolution Department demonstrated a high level of awareness and preparedness to manage a banking crisis. The exercise helped identify some challenges, particularly related to interagency cooperation where the legal framework leaves room for interpretation, that will now be addressed.

> "FinSAC's design of the simulation exercise enabled a very granular assessment of the different resolution strategies. Their very comprehensive analysis of the authorities' performance and specific recommendations were a major plus."
>
> **Beatrice Popescu**
> Deputy Director
> Bank Resolution Department
> National Bank of Romania

UKRAINE: FINSAC ASSISTANCE ON BANK RESOLUTION AND DEPOSIT INSURANCE REFORM - SPECIAL FEATURE

FinSAC has been working since its inception to support Ukraine improve stability in its financial sector. Significant progress has been made to address the handling of failing banks, highlighted as problematic during the 2008 financial crisis. The Ukrainian Deposit Insurance Agency was transformed into a bank resolution authority and, with World Bank and FinSAC engagement, its operational, financial, and regulatory capacity were strengthened to cope with massive bank failures. New resolution tools were introduced and a mechanism for state participation in the resolution of systemically important banks was defined. Despite more than 90 bank failures since the beginning of 2014, the authorities in Ukraine have managed to restore public confidence, giving an important stabilization signal to the market.

Successful recoveries are rare though, due to substantial erosion of banks' asset base before insolvency is declared during the so called "problem bank stage" and related party lending. As a result, the Deposit Insurance Agency has been burdened by high compensation payments, which were borne by the government and taxpayers.

As part of the Action Plan implementing its Association Agreement with the EU, signed in 2017, Ukraine committed to align with the EU Deposit Guarantee Scheme Directive and BRRD. The National Bank of Ukraine, the Ukrainian Deposit Insurance Agency, and FinSAC established a joint working group to develop an enhanced bank resolution framework. A FinSAC technical assistance project in 2018 identified priorities and key areas for reform and work on these got underway in 2019, with FinSAC support, to overhaul the Bank Resolution and Deposit Insurance Laws.

Upgrading an existing legal framework to a resolution regime designed for more complex and developed financial systems is challenging, particularly so in Ukraine which is still recovering from a recent financial crisis and ongoing court cases. Aligning

revised legislation with EU frameworks appropriate to domestic governance structures and financial market conditions was a recurring theme in the project. FinSAC developed an alignment matrix; proposed adaptations to the Deposit Guarantee Scheme Law; and provided comments to draft legal amendments to the Banking Law. Throughout the process, the joint working group demonstrated a strong commitment to design a legal framework that would better deal with bank failures and provide more robust institutional underpinnings. In addition to several meetings at working group level, high level management meetings were organized to provide guidance on the conceptual design, in particular as regards the division of competences among the National Bank of Ukraine as supervisory authority and the Deposit Insurance Agency as resolution authority. FinSAC organized a workshop in May 2019 to outline progress and next steps for stakeholders. The two-day workshop in Kyiv, with a financial contribution from the Swedish International Development Cooperation Agency, was attended by 120 senior representatives of the National Bank, the Household Deposit Guarantee Fund, delegates of the parliament, the government (Ministry of Finance), and representatives of industry and civil society. For the new laws to pass, it was critical that the complex international standards were properly understood by stakeholders involved in the approval process. Participants discussed a wide range of topics and implementation challenges related to the new framework with high level international experts representing European authorities (including the European Central Bank, Single Resolution Board, Austrian Financial Market Authority, and the Central Bank of Portugal).

The proposed revised framework that was developed seeks to align with the EU but appropriately adapted to local financial market conditions and governance structures. Areas for divergence or postponement from European rules were identified. Some EU restrictions, including on state aid, were removed. Other aspects would be gradually phased-in, such as the creation of a resolution fund and regulating minimum requirements of eligible liabilities. There would be more flexibility on the use of public support as a last resort while mitigating moral hazard. Unlike the European two-tier framework, under which resolution is targeted only for banks in the public interest, Ukraine would maintain existing powers, such as a transfer of assets and liabilities for small banks if determined by a reduced public interest test. The draft legislation included the proposed creation of a Joint Resolution Council, a new collegiate body to provide non-binding advice to the National Bank of Ukraine and Deposit Insurance Agency at the interface between “going concern” and “gone concern”.

Earlier FinSAC technical assistance supported the introduction of recovery planning for domestic systemically important banks. FinSAC has been working towards integrating resolution planning in everyday practice in Ukraine. Ensuring banks' resolvability, in particular the development of loss absorbing capacity to recapitalize a bank, will take time and considerable effort.

The judiciary has an important role in reviewing the lawfulness of authorities' decisions to effectively ensure the protection of citizens' rights. FinSAC engagement has emphasized the need to find a balance between taking fast decisive resolution action to maintain financial stability while ensuring legal safeguards and judicial overview. Discussions on the administrative authorities' discretionary assessments and legal safeguards proved particularly challenging in light of ongoing court cases on recent bank resolution and nationalization decisions.

FinSAC suggestions for updating the Deposit Guarantee Scheme Law sought to ensure alignment with European legislation as much as feasible but with partial divergence, for example as regards the availability of deposits, the gradual increase of coverage level, or the investment into low-risk assets. The main adaptations relate to a proposed separation between the funds of the Deposit Insurance Agency and the Deposit Guarantee Scheme, the definition of depositors, and the coverage of legal entities. An issue to be addressed were differences in the underlying conceptual understanding of terminology. Ensuring common understanding of terms and concepts has been challenging, for example as regards the definition of a target level, contribution rates, or the purpose of stress testing. FinSAC proposed continuing with the possibility of using Deposit Guarantee Scheme funds for resolution financing in order to provide guarantees or liquidity based on the current practice given the absence of a resolution fund, in addition to the obligatory financing in line with the bail-in hierarchy as stipulated for under the BRRD.

This project is nearing completion, with the two new laws expected to be adopted in 2020. Implementation support continues under a new FinSAC 3 programmatic project (see pages 39-40), which will see increased engagement with the authorities to realign sub-laws and regulations with the newly adopted legal framework and operationalize recovery and resolution planning. The new framework will require additional resources and skills within both authorities and banks to ensure that fast and decisive action can be taken at an early stage, aiming to protect depositors and investors while safeguarding financial stability and avoid taxpayer bail-outs.

PROGRAMMATIC WINDOW

Over the past years, FinSAC has built a strong track record on the basis of focused, typically smaller stability-oriented technical assistance projects. As part of its third phase extension from the end of 2017, it introduced the possibility for interested countries to address technical assistance needs through a programmatic window. Programmatic projects cover more than one thematic pillar, are larger in size, and usually have a somewhat longer lifespan. The programmatic window allows FinSAC to better serve the needs of countries whose financial stability needs cover a broader range of areas. It enables FinSAC to meet client demand in a more comprehensive and systematic manner.

ONGOING PROGRAMMATIC PROJECTS

ALBANIA: BANK SUPERVISION, RESOLUTION, AND NPLS

The Law on the Recovery and Resolution of Banks in Albania was enacted in 2016, providing the basis for a modern bank resolution framework aligned with the EU Acquis. In 2019, FinSAC began a two-year programmatic project, building on a series of earlier FinSAC technical assistance projects, aimed at providing the Bank of Albania with technical assistance in a more systematic manner. It is centered on bank resolution but also includes other areas of FinSAC expertise.

During 2019, the project focus was mostly on the design and operationalization of recovery measures and supervisory resolution actions. FinSAC provided comments on a draft law to define a methodology for calibrating the minimum requirement for own funds and eligible liabilities, taking into account recent developments at the EU level, in particular BRRD 2. FinSAC also assisted the Bank of Albania in the development of a Bail-In Note to operationalize bail-in. The Note will provide guidance on the execution of a theoretical and standardized bail-in scenario for relevant stakeholders and banks that fall under the responsibility of the Bank of Albania.

FinSAC developed a questionnaire to help identify necessary steps and legal requirements for bail-in under the local regulatory framework. The results of the questionnaire were discussed at a workshop in July 2019 and used to develop a first version of the Note for the Bank of Albania. Draft resolution plans for a sample of banks were shared by the Bank of Albania for discussion at an internal workshop with FinSAC in early 2020.

As the project progresses into 2020 other areas of focus will include assistance on the operationalization of the public interest assessment. This involves the development of a methodology for gauging the level of systemic threat emanating from a failing bank. FinSAC will offer capacity building and training for the Albanian Deposit Insurance Agency on the different purposes and roles of the deposit guarantee scheme and resolution financing. The project will also renew its focus on enhancements of the NPL resolution framework including the development of a collateral valuation framework in the financial system, supporting the introduction of a new regulation on loan underwriting principles, and helping operationalize the new out-of-court NPL resolution framework.

BOSNIA AND HERZEGOVINA: BANK SUPERVISION AND RESOLUTION

FinSAC launched a multi-pillar programmatic window in 2018 to support authorities in Bosnia and Herzegovina strengthen financial stability under the framework for reform as recommended by the International Monetary Fund (IMF)/World Bank Financial Sector Assessment Program. In 2019, FinSAC assisted with the finalization of the methodology for banks' internal capital adequacy assessment process and cooperated with bank supervisors in Bosnia and Herzegovina throughout the year to facilitate adoption of a new supervisory review and evaluation process. This forward-looking, risk-based supervisory approach is aligned with European Central Bank and European Banking Authority standards and practices, based on a methodology that has been tailored to the local context through continuous consultations with Banking Agency authorities. To operationalize the methodology, FinSAC undertook a total of nine missions to Sarajevo and Banja Luka, supporting the authorities as they organized a pilot exercise for the new supervisory review and evaluation process. The pilot exercise involved more than 25 staff responsible for the supervision of six commercial banks in Bosnia and Herzegovina. It was launched in April 2019 with a two-day workshop organized by FinSAC in Sarajevo. The workshop provided specialized training on the assessment supervisory review and evaluation elements, including business model, internal governance and risk management, risks to capital, and risks to liquidity. It also outlined phases for officials to carry out detailed assessments along an annual supervisory cycle, from the collection of regulatory reports to the formulation of assumptive supervisory decisions and measures to inform future examinations.

The pilot exercise was conducted in parallel with ongoing supervisory work by the Banking Agencies under the CAMELS framework (a rating system that assesses the strength of a bank through six categories: capital adequacy, assets, management capability, earnings, liquidity, and sensitivity). This generated valuable insights and revealed multiple areas to fine-tune the methodology. FinSAC provided timely advice to supervisory staff as officials assessed the profile of supervised banks to resolve emerging queries and facilitate technical discussions with supervisory committees. FinSAC also devised an automated toolkit, to be integrated in the Agencies' information management systems, to assist supervisors in organizing the documentation and analysis for the supervisory review and evaluation process. Conclusions drawn from the supervisory risk assessments were applied to formulate assumptive examination measures as part of the pilot exercise, up to the point of drafting legal communication letters to supervised banks.

> "We sincerely appreciate FinSAC's cooperation and assistance in introducing the new supervisory approach. Now fully implemented, this is one of the most important regulatory tools for assessing the capital and liquidity requirements of each bank."
>
> **Jasmin Mahmuzic**
> Director
> Banking Agency of the Federation of Bosnia and Herzegovina

The pilot exercise was successfully concluded in November and the finalized methodology, amended by the two entity Banking Agencies to suit local needs, was adopted in December 2019 to come into effect in January 2020. New horizontal units responsible for supervisory methodology, reporting, internal modeling, and stress testing have been set up by the Banking Agencies to better implement it. In early 2020, FinSAC will join the Banking Agencies in providing training for all bank supervisory staff in Sarajevo and Banja Luka. FinSAC will also facilitate adoption of the methodology for the internal liquidity adequacy assessment process. Further work will be undertaken on the bank resolution component of this program, including a workshop on resolution planning.

NORTH MACEDONIA: MACROPRUDENTIAL, CRISIS PREPAREDNESS, AND BANK RECOVERY & RESOLUTION

FinSAC's programmatic technical assistance to the National Bank of North Macedonia covers macroprudential frameworks, crisis preparedness, bank recovery and resolution, and the development of a supervisory challenger model. The project was initiated in February 2019 as a response to the 2018 Financial Sector Assessment Program Update and has already resulted in considerable progress.

In the area of macroprudential frameworks, FinSAC reviewed and provided detailed comments on the new draft memorandum of cooperation for maintaining financial stability. The memorandum aims to delineate the roles and responsibilities of all financial sector regulators and the Deposit Insurance Fund in terms of macroprudential policy, crisis preparedness, and crisis management. It is expected to be adopted in early 2020.

On bank recovery and resolution, FinSAC worked extensively with the National Bank through on- and off-site work in drafting a new Bank Recovery and Resolution Law and on establishing a Resolution Department in the National Bank. In the context of drafting the new law, FinSAC delivered a series of workshops covering valuation in resolution, resolution triggers, resolution tools, resolution planning, resolvability assessment, minimum requirement for own funds and eligible liabilities, changes in EU requirements, and resolution funding. The new law is expected to be adopted in 2020. Regarding recovery planning, FinSAC reviewed the first round of recovery plan assessments undertaken by the National Bank and identified ways to harmonize and further improve the assessments. Based on the review, FinSAC developed recovery plan assessment guidelines and templates which will be used for assessments going forward.

The development of a supervisory challenger model progressed well over the course of the year. The model will be used as a benchmark to assess banks' internal provisioning models for stress testing and other possible uses. Work on preparing the database and developing a draft rating system and risk quantification model, based on data stored in the National Bank's national credit and central registries, has been completed. Staff also received intensive training on modelling techniques and directly applied gained knowledge in the modelling process. The National Bank is finalizing the first version of the rating model and producing a first version of the probability of default model, with support from FinSAC.

UKRAINE: BANK RECOVERY AND RESOLUTION, MICRO-PRUDENTIAL FRAMEWORKS, AND NPL RESOLUTION

This programmatic project began in 2019 and builds on FinSAC's previous engagements with Ukraine. As outlined earlier, FinSAC has been assisting the Ukrainian authorities in revising the legal frameworks for bank resolution and deposit insurance. Once the Ukrainian Parliament adopt the legislation, FinSAC will continue its active engagement to realign sub-laws/regulations with the newly adopted legal framework.

One aim is to bring Ukraine closer to meeting international standards in the areas of capital adequacy and liquidity for banks. On capital adequacy, FinSAC assisted the National Bank to complete the drafting of amendments aimed at introducing capital regulation instruments with write-down/conversion mechanisms. A new regulatory capital instrument came into force in 2019 and is designed to help banks raise more capital with loss absorption capacity. FinSAC also supported the introduction of a new methodology for calculating banks' regulatory capital which was endorsed by the National Bank in December 2019 and constitutes the reference for banks to calculate their capital in line with the EU. This marks a new phase for the design of reporting templates for banks, the drafting of technical annexes, and a testing period for the new requirements. The methodology will become a binding regulation once the necessary amendments to the Banking Law are approved by the Parliament. In parallel to the new capital structure, the capital conservation buffer will be introduced progressively from January 2020 raising the total capital by 2023 to a minimum of 12.5%, to which a 1-2% buffer will be added for systemically important banks.

On liquidity, the liquidity coverage ratio reform, supported by FinSAC and which included a 6-month quantitative impact study, has been completed. The regulation establishing the Basel III liquidity coverage ratio entered into full implementation in 2019 with banks being required to calculate daily and report accordingly at solo basis their liquidity coverage ratio. The procedure setting the requirements for calculating the net stable funding ratio, designed with FinSAC assistance, were approved by the National Bank Board in December 2019.

Going forward, during the first half of 2020, the National Bank will develop reporting templates for banks as part of the testing phase. A new liquidity standard is set to enter into force in 2020 with full implementation in 2021. Work on calculating banking groups' regulatory capital at the consolidated and sub-consolidated levels will be pursued. A new draft on regulatory capital calculation has been produced and will be discussed with the Banking Society in the third quarter of 2020. In addition, the National Bank has drafted a new Regulation on Capital Adequacy Requirements for Operational Risk which will be issued after the necessary amendments to the Banking Law. Further work will be delivered on capital adequacy requirements for market risks. Moreover, a new workstream on the leverage ratio will commence later in 2020 and FinSAC has been asked to provide additional support on two new items, the large exposure limits and the risk weight assets calculation for credit risks under the Basel standardized approach.

Work is ongoing to support the implementation of the new NPL governance and workout regulation, including the NPL workout strategies and resolution planning, and the further enhancement of broader NPL resolution frameworks. In 2019, FinSAC continued supporting the authorities in their efforts to enhance the NPL resolution framework in Ukraine. Under the regulatory pillar of the framework, the NBU issued Regulation #97 on Organization of the Process for Management of Problem Assets in Ukrainian Banks in July 2019, the result of a multi-year project. It sets a unified NPL resolution

framework in Ukraine and provides detailed guidance for banks on dealing with their NPLs. FinSAC undertook a detailed analysis of the NPL stock (which is concentrated primarily in state-owned banks) and proposed a resolution strategy. FinSAC also assisted the National Bank in drafting a new regulation on NPL write-offs, building on international experience but adapted to local specifics, to be finished in early 2020. It is expected that the enhanced NPL regulatory framework will facilitate a significant reduction of NPLs in 2020.

> "Our deep gratitude for the fruitful cooperation and World Bank's valuable contribution to the important work on the development of the Regulation Organizing Non-Performing Assets Management in Ukrainian banks and the Regulation on Recovery Plans of Ukrainian Banks and Banking Groups."
>
> Methodology Department
> National Bank of Ukraine

While the National Bank has made substantial progress in the regulatory field, further efforts were needed to address asset (collateral) valuation. At the request of the State Property Fund, the regulator of the sector, in 2019 FinSAC reviewed the valuation framework to propose reform actions. Areas identified include (i) methodology for automatically determining the appraised value of real estate, (ii) review of valuation standards, (iii) improvements in valuation framework, and (iv) improvements in experts' education and licensing. This will be a special focus for FinSAC's engagement in 2020. It is expected that the authorities, with FinSAC's support, will adopt new valuation standards and introduce new enhanced regulatory requirements for appraisers.

In terms of expected outcomes, the finalization of the new legislative framework and the issuance and implementation of the regulatory reforms described above should significantly transform the overall soundness and functioning of the banking sector in Ukraine.

SECTION 5: KNOWLEDGE ACTIVITIES IN 2019

FinSAC seeks opportunities to share its expertise and raise awareness of topics of particular relevance to its client countries. It achieves this through the hosting of thematic international conferences, seminars, and workshops; the production of papers and other documents on topics relevant to client countries (and beyond); and by building networks among client countries and in the wider international community including through participation at conferences and events on related subjects. Many projects already described include knowledge activities such as seminars and workshops directly related to technical assistance. In addition, in 2019, FinSAC held its annual international conference and produced three knowledge products.

FINSAC INTERNATIONAL CONFERENCE ON FINTECH

Each year FinSAC uses its convening power to focus attention on one major topic of financial stability. In 2019, the FinSAC International Conference on Fintech was held in Vienna, May 22-23. In line with FinSAC's core mandate, fintech related issues and concepts were approached from a stability angle for the target audience of central bankers and prudential regulators in the ECA region and more widely. The conference aimed to dissect the main areas relevant for this audience, recognizing the importance of their awareness and knowledge about the main technologies spurring financial services evolution and related issues: fintech overview; regulatory and supervisory approaches to fintech; use of information technology to enhance regulatory processes (regtech) and to support supervision (suptech); operational risk in fintech environment; crypto assets/blockchain; distributed ledger technology use in payments; and digital credit evolution and implications for regulators/supervisors.

The event took advantage of World Bank expertise as moderators and speakers, joined by 24 speakers and two moderators from public, private, and academic sectors, and other multilateral organizations. The almost 150 participants represented 66 different entities from 31 countries. Attendees included 15 private companies; six research/academic

institutions, the Bank for International Settlements' Financial Stability Institute; the European Central Bank, European Banking Authority, and Basel Committee on Banking Supervision. Participant evaluations revealed that the event was very well received with an overall score of 4.8 on a five-point scale.

FinSAC's annual conference helps cement its reputation as a center of expertise and knowledge-sharing. This successful event allowed client country regulators, supervisors, and central bankers, as well as FinSAC donors, other stakeholders, and outside partners in the field to gain a deeper understanding of the highlighted fintech areas. The event helped regulators and central bankers across the region in developing a better understanding of the nature of fintech, its potential repercussions from a financial stability angle, and fostered discussions among participants, including on what these technologies mean and may mean to them in the future.

The full agenda with speakers' bios and presentations (where used and approved for public release) are available on the FinSAC website.

WORKING PAPER ON CROSS BORDER BANKING SUPERVISION AND RESOLUTION: THE SMALL HOST PERSPECTIVE AND LAUNCH EVENT

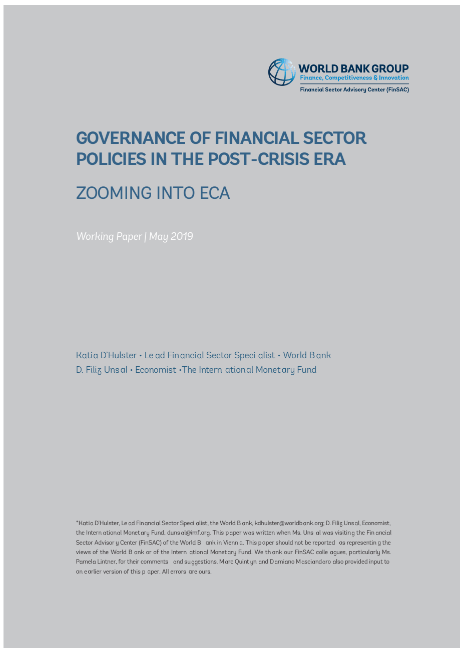
Banking sectors in Central, Eastern and South Eastern Europe are generally dominated by European banks. Moreover, the operations of these European banks are often systemic in the host country but not material to the parent bank and thus the home country authority. Host countries in this position are referred to as "small hosts", and they face unique policy and implementation challenges. The FinSAC working paper "Banking supervision and resolution in the EU: Effects on small host countries in Central, Eastern and South Eastern Europe" was published in 2019 and analyzes the consequences of recent EU reforms in the area of supervision and resolution

from the perspective of small host countries and makes recommendations, directed to both EU and small host countries' authorities, on how to best address these challenges.

FinSAC held a launch event in Vienna in 2019 to discuss the conclusions and recommendations of the report. The event was attended by representatives of the European Banking Authority, the European Central Bank, the Single Resolution Board, and senior officials from central banks, banking agencies, and other prudential supervisory and resolution authorities from countries in the eurozone and from client countries. The event generated interesting discussions on topics including cooperation and management of diverging interests between home and host countries within and outside the EU; what has been achieved on cross border bank resolution; and the implications of single or multiple points of entry resolution strategies. The event was very well received by participants who rated it a maximum 5 out of 5 in a post-event survey.

WORKING PAPER ON GOVERNANCE OF FINANCIAL SECTOR POLICY FUNCTIONS IN ECA

In 2019, FinSAC published a working paper "Governance of Financial Sector Policies in the Post-crisis Era: Zooming into ECA". It zooms into governance arrangements that ensure effective coordination and collaboration among three policy functions: macroprudential supervision, microprudential supervision, and bank resolution. The paper addresses coordination and information exchange across these policy areas, decision-making processes and the resolution of potential conflict and tensions, both in normal and in crisis times. Even where the microprudential supervisor is part of the central bank, information to the other areas the central bank is responsible for (e.g. financial stability and lender of last resort) does not always flow smoothly and promptly.
This paper builds on the findings from an extensive survey on governance practices in 13 ECA countries and eight (high-income) benchmarking countries, aimed at documenting practices, and identifying policy recommendations for ECA. The need for a governance framework that ensures effective collaboration and coordination among the three policy functions, in addition to the well-functioning of each policy, is increasingly being recognized among ECA countries. The survey results, however, indicate that there is room for improvement in financial policy governance in ECA and that crisis management frameworks are in their infancy. The role of the institutional structure is to support supervisors and regulators in effectively discharging their duties. The survey points towards the need for a clear legal framework and strengthened practices that ensure sound governance for each policy; strong coordination and collaboration among policies; and effective crisis management frameworks. The paper presents common practices and policies that focus on coordination and collaboration. It suggests that coordination arrangements should be formalized between agencies in a way that offsets any tendency to be territorial and instead encourages information flows on policy matters of interest to all parties.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GOVERNANCE OF FINANCIAL SECTOR POLICIES IN THE POST-CRISIS ERA

ZOOMING INTO ECA

Working Paper | May 2019

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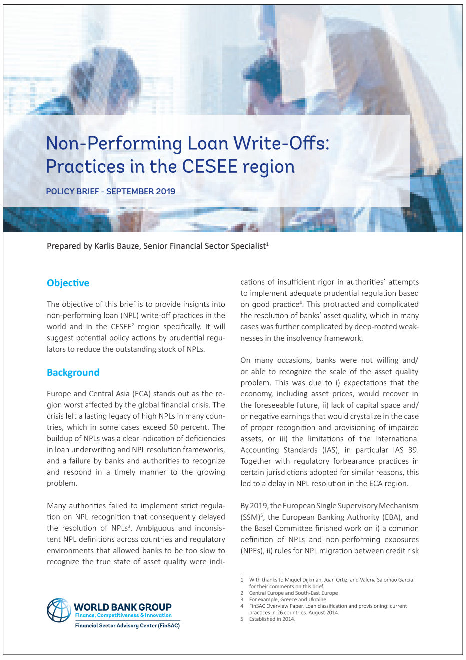
POLICY NOTE: NPL WRITE-OFFS



Non-Performing Loan Write-Offs: Practices in the CESEE region

POLICY BRIEF - SEPTEMBER 2019

Prepared by Karlis Bauze, Senior Financial Sector Specialist[1]

Objective

The objective of this brief is to provide insights into non-performing loan (NPL) write-off practices in the world and in the CESEE[2] region specifically. It will suggest potential policy actions by prudential regulators to reduce the outstanding stock of NPLs.

Background

Europe and Central Asia (ECA) stands out as the region worst affected by the global financial crisis. The crisis left a lasting legacy of high NPLs in many countries, which in some cases exceed 50 percent. The buildup of NPLs was a clear indication of deficiencies in loan underwriting and NPL resolution frameworks, and a failure by banks and authorities to recognize and respond in a timely manner to the growing problem.

Many authorities failed to implement strict regulation on NPL recognition that consequently delayed the resolution of NPLs[3]. Ambiguous and inconsistent NPL definitions across countries and regulatory environments that allowed banks to be too slow to recognize the true state of asset quality were indications of insufficient rigor in authorities' attempts to implement adequate prudential regulation based on good practice[4]. This protracted and complicated the resolution of banks' asset quality, which in many cases was further complicated by deep-rooted weaknesses in the insolvency framework.

On many occasions, banks were not willing and/or able to recognize the scale of the asset quality problem. This was due to i) expectations that the economy, including asset prices, would recover in the foreseeable future, ii) lack of capital space and/or negative earnings that would crystalize in the case of proper recognition and provisioning of impaired assets, or iii) the limitations of the International Accounting Standards (IAS), in particular IAS 39. Together with regulatory forbearance practices in certain jurisdictions adopted for similar reasons, this led to a delay in NPL resolution in the ECA region.

By 2019, the European Single Supervisory Mechanism (SSM)[5], the European Banking Authority (EBA), and the Basel Committee finished work on i) a common definition of NPLs and non-performing exposures (NPEs), ii) rules for NPL migration between credit risk

1 With thanks to Miquel Dijkman, Juan Ortiz, and Valeria Salomao Garcia for their comments on this brief.
2 Central Europe and South-East Europe
3 For example, Greece and Ukraine.
4 FinSAC Overview Paper. Loan classification and provisioning: current practices in 26 countries. August 2014.
5 Established in 2014.

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In recent years, international standard setting bodies have issued detailed guidelines on critical aspects of NPL resolution, including through the identification of best practices for loan loss classification, efforts to develop markets for distressed assets, and a strengthening of the legal environment for creditor rights. One area that has received comparatively little attention are loan write-off practices, which have been left for banks to decide on. A FinSAC policy note "Non-Performing Loan Write-Offs: Practices in the CESEE region" summarizes international loan write-off practices with the emphasis on, and examples from, Central and Eastern Europe. The paper has a particular relevance for FinSAC countries, many of which have in recent years relied heavily on loan write-offs as a means to reduce NPL volumes. Effective write-offs require that tax and legal impediments are properly addressed. Other prerequisites for effective NPL write-offs are prudent and well-enforced frameworks to identify and provision for problem assets (including stringent criteria for loan restructurings), and prudent collateral valuation frameworks. With these preconditions in place, some countries have achieved positive outcomes with the introduction of mandatory write-off policies, requiring banks to write-off loans that have spent a certain amount of time in the loss category. The paper also suggests that regulators should have the discretion to decide on the most appropriate form of regulation and that prudent provisioning and write-off rules should be introduced during a period of economic stability or growth to make it easier and provide a necessary counter-cyclical buffer.

KNOWLEDGE ACTIVITIES ONGOING INTO 2020

BANK RECOVERY AND RESOLUTION JUDICIAL PRACTICE: SELECTED COLLECTION OF COURT RULINGS

There are many court cases pending at present in EU countries in connection with bank resolution procedures. This highlights the complexity of the legal issues inherent in dealing with failing banks while aiming to safeguard financial stability and without resorting to public support. Responding to an increasing demand from client countries for guidance on the role of the judiciary in bank resolution and liquidation, FinSAC has started a collection of court rulings deciding on appeals against bank resolution/liquidation decisions. This collection includes rulings from EU countries as well as the United States and covers a variety of legal aspects pre and post BRRD. These case studies will provide a source of information for authorities and support FinSAC technical assistance projects. They can be used as guidance in the design of resolution regimes and on the alignment of client countries' resolution frameworks with international good practice, help better assess potential litigation risks, as well as improve understandings of constitutional and fundamental rights concerns in bank resolution. This project will be finalized in 2020. The final output will be a paper that will be made available online.

KOSOVO: STOCKTAKING PAPER ON THE EVOLUTION OF THE CORPORATE GOVERNANCE OF SOUTH EUROPEAN BANKS

At the request of the Central Bank of Kosovo, FinSAC is reviewing the adoption of international good practices in corporate governance of banks in Kosovo and in four other Western Balkan countries (excluding Serbia). The goal is to assist country authorities with future reforms of their corporate governance framework.

The paper uses data obtained in a survey of banks in the region, organized by the Central Bank of Kosovo in conjunction with the Central Banks of Albania, the Federation of Bosnia and Herzegovina, Montenegro, and North Macedonia. Provisional findings were presented in November 2019 at a conference marking the 20th anniversary of the founding of the Central Bank of Kosovo. Analysis of the survey data was completed in December 2019 and the final paper will be produced in the first quarter of 2020. Preliminary findings include that bank governance practices in the region are converging on international good practice, although with some distinct regional features. Many practices are driven by the fact that most banks are subsidiaries of international banks. Notable observations include:

- Boards are relatively small, non-resident board members are common, and board member independence is increasing.
- Bank boards appear to have the power and authority to play the central and strategic role assigned to them by international good practice.
- Audit committees, a key feature of international good practice, are in place in almost every bank.
- Risk committees, a key feature of the post global financial crisis good practice, are about half as common as audit committees but their use is growing rapidly.
- Reported disclosure and transparency is close to international standards.

The regional central banks plan to continue to update and upgrade the survey. Other possible next steps to better understand corporate governance practices in the region could include in-depth assessments of corporate governance of individual banks, more detailed inter-country comparisons of regulation (and benchmarking against EU regulation and international good practice), or joint roundtables with foreign banks to better understand the group governance practices of foreign banks with large presences in the region.

RESOLUTION BAIL-IN SIMULATOR TOOL

The FinSAC bail-in simulator was designed as a tool to better understand the practical implications in terms of loss allocation of using bail-in. It is an Excel-based calculator that allows users to compare different resolution options using a fictitious balance sheet. Its first use with clients, as part of the Romanian resolution simulation exercise in 2018, highlighted areas for further fine-tuning work which was undertaken during 2019. FinSAC obtained additional inputs from Austrian Financial Market Authority experts on legal details and practical usage. With the technical work on the simulator nearing completion, the team is assessing the feasibility of converting the tool into a more user friendly web-based program that can be used more widely for training, in seminars and workshops, as well as part of resolution simulation exercises.

WORKING PAPER: FINANCIAL STABILITY COMMITTEES IN EASTERN EUROPE AND CENTRAL ASIA

One of the takeaways from the global financial crisis is the need to add a macro overlay to existing frameworks focusing on ensuring the stability of individual financial entities. Subsequently, countries have moved forward to establish proper institutional arrangements for the monitoring and timely mitigation of threats to financial stability that are building up at the level of the financial system. The nature of macro-financial risks spanning across financial institutions, markets, and the real economy requires timely dialogues and decisions among officials responsible for a country's financial stability. Accordingly, many countries have established financial stability committees, comprising typically the central bank, prudential regulator, ministry of finance, among other agencies, to translate systemic risk concerns to corrective policies.

FinSAC has observed considerable variation in the design of financial stability committees among client countries. To better understand the extent to which the performance of financial stability committees in facilitating macroprudential policies can be attributed to their underlying design features, FinSAC is conducting a study drawing on three forms of evidence. The first is a detailed stock-take of de jure institutional characteristics, in terms of mandate, legal basis, power, lead agency, and decision-making mechanism. This is conducted through careful review of relevant laws and memoranda as well as through fact-checking with country regulatory experts. The second aspect is a quantification of technical assessments regarding the severity of systemic risk factors, including on general credit and liquidity conditions, sectoral risks, and transmission channels. This is accomplished by applying natural language processing methods to a large body of financial stability reports and other official documents to determine the perceived intensity of specific risks over time. The third aspect is a comprehensive classification of implemented macroprudential policies, as documented by the IMF, World Bank, European Central Bank, and previous research, according to the risk factors they generally aim to address. These findings are analyzed collectively using regression models.

FinSAC presented its preliminary findings in November 2019, during the 2nd World Bank Finance, Competitiveness & Innovation Knowledge Week. These indicated that a dedicated financial stability mandate combined with technical capacity in leadership is foundational to the success of financial stability committees in monitoring and addressing emergent systemic risks. It also revealed that strong power over policy instruments, provided through a formal legal basis with checks and balances for their use, is a critical determinant of effective policy response. Such findings echo the 2011 Single Resolution Board's recommendation for national macroprudential authorities in the EU and provides support to future institutional reforms to strengthen financial stability in FinSAC client countries.

POLICY PAPER: RELATED PARTIES TRANSACTIONS AND ASSOCIATED RISKS

Multiple recent cases of bank failures in ECA (e.g. Ukraine, Moldova, Bulgaria, Russia, and Azerbaijan) and beyond have highlighted the critical importance of related party lending (loans to shareholders, affiliates, and associates) for banking stability. Mostly based on field work, this FinSAC study aims to strengthen the regulatory regime for connected lending as well as supervisory authorities' capacity to effectively oversee these transactions to preempt bank failures that cost billions of dollars to tax payers in emerging markets.

Field work commenced in the last quarter of 2019 in several countries in the EU as well as in Moldova and Ukraine. Early findings suggest that the issue of related party transactions is still a matter of concern for supervisors and regulators. The degree of harmonization in Europe around policies governing related party transactions is limited and several jurisdictions are still lacking prudential limits. Definitions of related parties are often too narrow and do not comply with the Basel standards, that also leave supervisors with a certain measure of discretion to identify related party exposures. Further, rules governing related party transactions are skewed towards credit and tend to be less specific on other types of transactions, such as guarantees as well as off-balance sheet exposures and claims. Disclosures principles and reporting mechanisms also warrant improvements. Lastly, supervision needs to be more assertive and sanctions imposed more forcefully in case of breach. The policy paper is expected to be published in the course of 2020.

SHARING FINSAC KNOWLEDGE AND EXPERTISE IN 2019

Over the course of 2019, FinSAC experts participated in a variety of knowledge events, cooperating with international organizations and relevant bodies in client countries and beyond to share knowledge and experience and deepen understanding of relevant issues. FinSAC has been particularly keen to establish strong cooperation with the EU bodies, given the importance of EU standards in guiding client country reform efforts. The cooperation with other Finance, Competitiveness & Innovation Global Practice knowledge hubs was strengthened through FinSAC's participation in an NPL conference in Kuala Lumpur (which was based on the 2018 FinSAC international conference in Vienna) and a field visit to Seoul (combined with FinSAC's participation in a forum for asset management companies). Participation in these events helped deepen existing and build new cooperative networks on financial stability themes including with the Joint Vienna Institute, think tanks, and international and European standard-setting bodies. FinSAC has also invited experts from these agencies to join as panelists in its knowledge events.

APR	**Kuala Lumpur** Malaysia	Presentation on ECA's experiences in NPL resolution and on collateral valuation at a two-day NPL conference
JUN	**Frankfurt** Germany	Panel Presentation on internal minimum requirement for own funds and eligible liabilities at the Infoline Bank Resolution Conference
JUN	**Istanbul** Turkey	Presentation on bank resolution funding at the World Bank/Turkey Savings Deposit Insurance Fund workshop
JUL	**Istanbul** Turkey	Presentation on NPL resolution at the World Bank/European Bank of Reconstruction and Development workshop
JUL	**Istanbul** Turkey	Presentation on international experiences with corporate viability assessment framework to the Turkey Banking Regulation and Supervision Authority
AUG	**Dhaka** Bangladesh	Presentation on NPL resolution experiences in the EU at the Bank of Bangladesh management retreat

SEP	**Basel** Switzerland	Participation in the 9th Financial Stability Institute and International Association of Deposit Insurers Conference on crisis management, bank resolution and deposit insurance
SEP	**Vienna** Austria	Participation in a four-day NPL resolution seminar jointly organized by the Joint Vienna Institute, European Central Bank, and FinSAC
SEP	**Seoul** South Korea	Participation in a panel on the Annual International Public Asset Management Company Forum
OCT	**Istanbul** Turkey	Presentation on deposit insurance systems at the International Association of Deposit Insurers' Annual Conference
OCT	**Brussels** Belgium	Panel presentation on the regime for non-viable cross-border banks at the Bruegel Closed Door Workshop on bank resolution: consistency and predictability
OCT	**Zurich** Switzerland	Meeting on resolution strategies, minimum requirement for own funds and eligible liabilities/total loss-absorbing capacity and bail-in calculation with the Swiss Financial Market Supervisory Authority
NOV	**Riga** Latvia	Participation in a one-day workshop on NPL resolution framework for the staff of the Financial and Capital Markets Commission of Latvia
NOV	**Dhaka** Bangladesh	Participation in a two-day seminar on asset management companies by the Asian Development Bank
DEC	**Brussels** Belgium	Participation in a Bruegel Closed Door Workshop on single/multiple points of entry resolution strategies

SECTION 6:
OUTCOMES AND RESULTS

2019 was another productive year for FinSAC, with strong client demand for bilateral technical assistance covering the full range of FinSAC's product offerings. This reflects a variety of factors, including continued client country commitment to strengthen financial systems through enhanced legal, regulatory, and supervisory frameworks, as well as a high level of trust in FinSAC as a provider of technical assistance tailored to the context of client countries. Stable client demand also underscores the relevance of FinSAC's development objective, to support eligible client countries in building stronger, more resilient financial sectors.

This chapter reviews the outcomes and results of the activities concluded in 2019. Over the years, FinSAC has been undertaking measures to better understand and demonstrate how its work contributes to its development objective, including through client satisfaction surveys and through an enhanced monitoring and evaluation framework that has been phased in for projects financed under FinSAC 3.

A SNAPSHOT OF 2019

In 2019, FinSAC completed 13 projects in total. This included nine technical assistance projects, three knowledge products, and the annual FinSAC conference – this year on fintech (other knowledge events including a launch event of the working paper on the small host paper, and a workshop in support of the Ukraine bank resolution technical assistance project were wrapped into existing projects). The portfolio of completed projects in 2019 covered the full thematic range of FinSAC's product offerings. Four projects covered topics related to financial stability, crisis preparedness, and deposit insurance frameworks, while FinSAC completed eight projects in the field of bank supervision and one in the area of bank resolution.

With these achievements, FinSAC met its targets to complete at least nine technical assistance projects, organize two knowledge events, and produce one analytical piece per year. The following two tables present a complete overview of all projects by countries, pillars, and deliverables.

Table 1: Structure of completed projects by deliverables, pillars, and countries

Completed projects by deliverables	Pillar 1	Pillar 2	Pillar 3	Total
Knowledge events/products	0	4	0	4
Technical assistance	4	4	1	9
Total	**4**	**8**	**1**	**13**
Completed projects by country/pillar	**Pillar 1**	**Pillar 2**	**Pillar 3**	**Total**
Belarus	1	–	–	1
Georgia	1	–	–	1
Kosovo	1	–	–	1
Moldova	–	–	1	1
Montenegro	–	1	–	1
Serbia	1	1	–	2
Ukraine	–	1	–	1
Uzbekistan	–	1	–	1
Regional	–	4	–	4
Total	**4**	**8**	**1**	**13**

Table 2: List of completed technical assistance projects in 2019

Country	Technical Assistance
Belarus	Assessment of Cyber Security Regulations for the Financial Sector
Georgia	Cyber Crisis Simulation Exercise
Kosovo	Improving Crisis Management and Strengthening the Deposit Insurance Fund
Moldova	Bank Resolution Framework
Montenegro	Strengthening the Bank Recovery and Resolution Framework
Serbia	Strengthening the Foundations and Analytical Basis for the Deposit Insurance System
Serbia	Corporate Indebtedness and Prevention of NPLs
Ukraine	Improving the Quality of Banking Regulation in line with the EU Framework
Uzbekistan	New Banking Law and Guided Basel Core Principles Self-Assessment

Date	Knowledge Events/Products
May 22-23, 2019	FinSAC International Conference on Fintech
Q1, 2019	Working Paper on Cross Border Banking Supervision and Resolution: The Small Host Perspective and Launch Event
Q2, 2019	Working Paper on Governance of Financial Sector Policy Functions in ECA
Q3, 2019	Policy note: NPL Write-Offs

CLIENT COUNTRY FEEDBACK

As in previous years, FinSAC conducted client surveys for all projects completed in 2019, inviting beneficiaries of its technical assistance projects to provide feedback. The outcomes help FinSAC to understand whether projects have effectively addressed clients' needs, identify areas for improvements, improve the design of new technical assistance projects, and foresee prospective client demand.

Feedback was received for all projects completed in 2019 and recipients reported high levels of satisfaction, with most scores very close to levels observed in previous years. The results remain steady from 2018 and show that FinSAC's effort and work are highly valued by its clients; average scores for overall satisfaction and the quality of deliverables specifically were 4.22 and 4.11 respectively on a five-point scale, indicating satisfaction above expectations. The timeliness of deliverables and performance of consultants showed a slight deterioration in clients' satisfaction, while the performance of World Bank staff was valued higher in 2019 compared to 2018. Respondents did not highlight any areas where project performance was below clients' expectations.

The 2019 survey also sought beneficiaries' views on what they see as the main outcomes from FinSAC technical assistance projects, i.e. any positive short- and medium-term effects that have been achieved with FinSAC support. A predefined list of outcome indicators was included, and respondents were asked which, if any, were applicable. Clearly, the expected outcomes depend on the nature of the technical assistance and the results vary across the

three thematic pillars. Two outcomes stood out; nine respondents indicated that FinSAC assistance has helped to align existing legal, regulatory, and supervisory frameworks with international best practices, and seven respondents highlighted that FinSAC had strengthened their capacity to articulate effective policies to promote financial stability. Convergence with applicable EU standards, more effective regulatory or legal frameworks for maintaining financial stability, strengthened analytical capacity to detect threats to financial stability, and stronger financial institutions were also areas (each of them highlighted by four correspondents) where respondents saw a positive FinSAC contribution.

Figure 1: Client satisfaction with FinSAC technical assistance

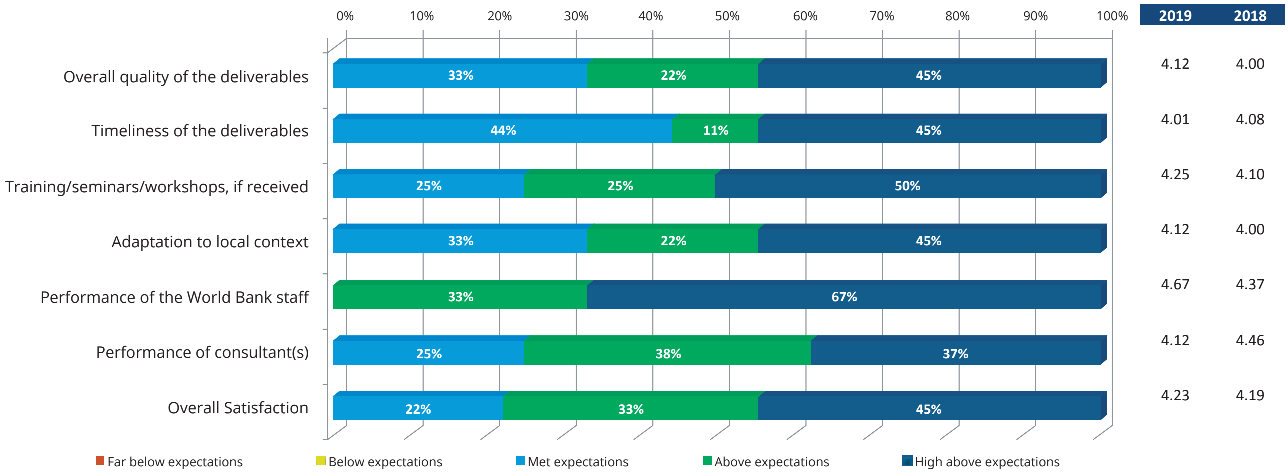
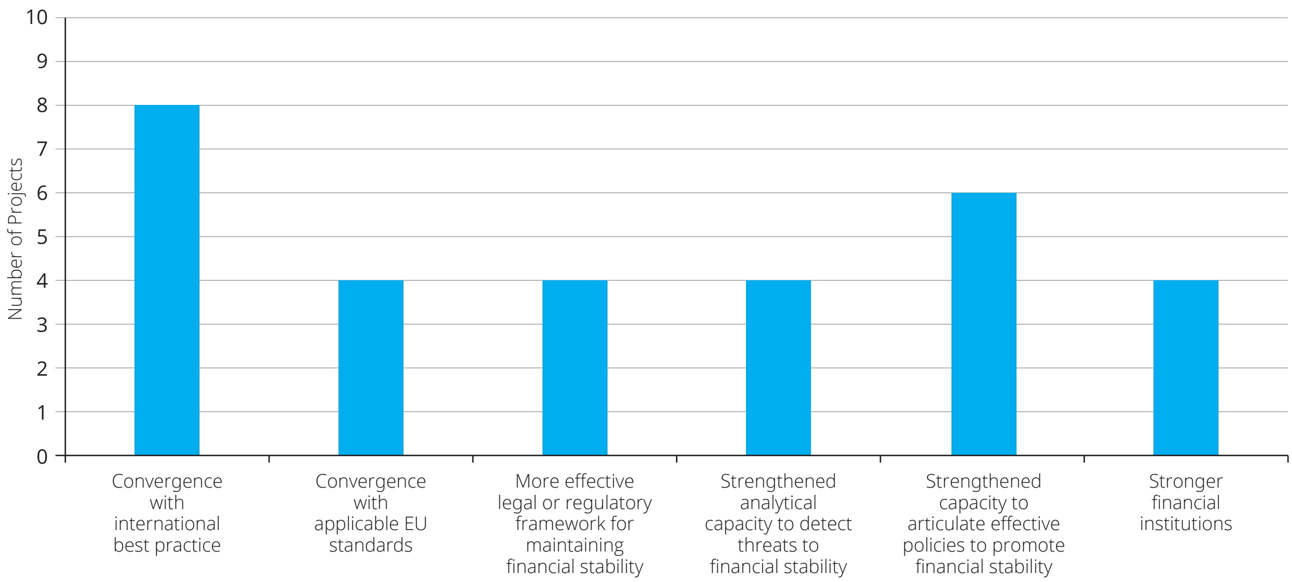


Figure 2: Main outcomes of FinSAC technical assistance in 2019



*Each project contributed to more than one outcome. Therefore, sum on the graph does not correspond to the total number of projects.

FINSAC WEBSITE

There were 2,372 visits to the FinSAC website in 2019 by 1,658 unique visitors. Among client countries, most visits were from Albania, Serbia, Ukraine, Bosnia and Herzegovina, and Georgia. There were also significant numbers of visitors from India, Malaysia, Turkey, and China, presumably as a result of FinSAC participation in external knowledge events.

In addition to the much downloaded Cyber Security Digest and related paper, other knowledge products downloaded in 2019 included the following.

ASSESSING OUTCOMES – POST-PROJECT MONITORING

FinSAC strengthened its monitoring and evaluation framework in 2018, applicable to all projects financed under FinSAC 3. The starting point of the new framework is the articulation of a much more elaborate results chain for individual projects included in the concept notes proposing new FinSAC projects. For new projects financed under FinSAC 3, the project team leader prepares log frames outlining: (a) expected outputs, i.e. what will be done; (b) anticipated outcomes, i.e. the positive medium-term effects that the proposed project seeks to achieve; (c) outcome indicators, i.e. indicators and threshold values that signal whether the targeted outcomes have in fact been achieved; (d) a baseline, i.e. the situation before FinSAC intervention; (e) time horizon, i.e. the point in time when the desired outcomes are expected to have materialized, usually six months or a year after conclusion of the project; and (f) the sources for verifying the outcome indicators.

Enhanced post-project monitoring is an integral part of the new monitoring and evaluation framework. This includes an assessment of whether the outcome indicators specified in the results chain at the concept note stage have been achieved within the expected time horizon. In most cases, this assessment requires inputs from the beneficiaries of FinSAC support, who can also provide a broader context and their qualitative insights about the impact of the project.

FinSAC 3 has now been in operation for more than two years and nine FinSAC 3 projects have been completed. As desired outcomes are rarely observable straight away, the "time horizon" for verification of the extent to which they have materialized usually takes place some time after completion of the project. Five completed FinSAC 3 projects are still within the post-project waiting period. This is the case for Belarus and Georgia (both cyber security simulations), Montenegro (bank recovery and resolution and legal alignment), Moldova (bank resolution), and Serbia (corporate health study). These projects will be discussed in next year's annual report. In addition, FinSAC completed its final FinSAC 2 projects in 2019 that did not have the expanded results framework.

This section therefore discusses the outcomes of four technical assistance projects completed in 2018 and 2019 for which the time horizon specified in the concept note has passed, or for which the outcome indicators have already been confirmed. These are projects in Ukraine (concluded in 2018), Kosovo, Serbia, and Uzbekistan (see project descriptions in Section 4). The general pattern emerging from this initial batch of FinSAC 3 projects is that the expected outcome indicators did materialize, although with some delays in the cases of Kosovo and Uzbekistan as full completion of these projects required extensions of the project completion dates.

UKRAINE

FinSAC 3's first technical assistance project was started and concluded in 2018 and aimed to support the National Bank of Ukraine in developing a methodology for assessing the sustainability of rapid consumer credit growth, which was the first segment to stage a recovery from the post-2014 banking crisis. The results chain for the project foresaw that – one year after the conclusion of the project – the new methodology would be being actively used by the National Bank as part of its financial stability monitoring work. This is indeed the case. The National Bank's Financial Stability Department has integrated the model into its ongoing monitoring work and is actively using the results of the modelling, including for its 2019 Financial Stability Report. It is also preparing a special feature in its quarterly bulletin explaining the methodology. The analysis performed for the 2019 Financial Stability Report indicated that at its current rate of expansion, consumer credit growth was still below the equilibrium ratio but was fast approaching the benchmark. The National Bank therefore decided to increase risk weights for consumer loans from 2021 for unsecured consumer loans.

KOSOVO

The Kosovo technical assistance project consisted of support to the Central Bank of Kosovo on crisis preparedness and targeted support to the Deposit Insurance Fund. Overall, it was successful in achieving the targeted outcomes, although the completion date was extended once to allow enough time for the full completion of the project. As foreseen in the results chain, the Central Bank fully implemented the recommendations from the project, as illustrated by the signing of a new memorandum of understanding establishing the revised Financial Stability Committee, the formal adoption by the Central Bank of new policies and procedures for its lender of last resort function, and the development of a public communication strategy and crisis binder for financial crises. The Central Bank indicated that these measures contributed to a significant enhancement of its crisis response capacity and has signaled its interest in continuing work on operationalizing the Financial Stability Committee under a new FinSAC project. The deposit insurance component of the project fully achieved its objective of strengthening interagency cooperation and information exchange through a signed memorandum of understanding between the Central Bank and the Deposit Insurance Fund. In addition, while the project originally foresaw technical support for the introduction of a differential premium system, this component evolved into broader support to prepare a deposit insurance funding policy. The new policy, approved by the Deposit Insurance Fund's Board, strengthens its capacity to assess on a continuous basis its funding needs given current coverage levels.

SERBIA

FinSAC's technical assistance project in Serbia fully achieved its targeted outcomes and within the expected time horizon. The project consisted of the development of a target fund size model and a full-fledged assessment against the International Association of Deposit Insurers' core principles, and targeted legal changes in the Deposit Insurance Law to reflect the outcome of the work. Following the conclusion of the project, the authorities amended the Law, establishing a legal basis for lowering the level of the relatively high deposit insurance contributions, the introduction of a target fund, and the possibility of charging risk-based premiums. In addition, the 2015 memorandum of understanding between the Deposit Insurance Agency and the National Bank of Serbia has been updated to enhance information sharing on banks' risk profiles and resolution plans.

UZBEKISTAN

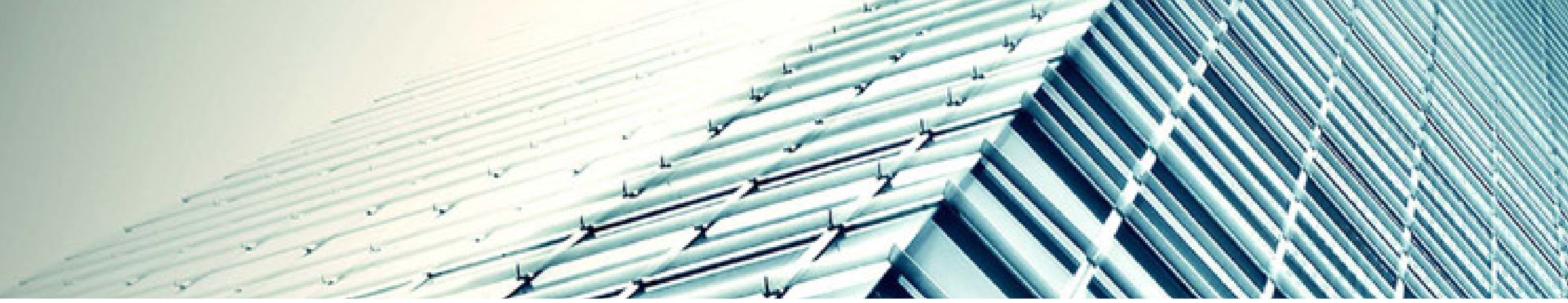
FinSAC's pilot project in Uzbekistan, which consisted of support in drafting a new Banking Law, and a supported self-assessment against the Basel Core Principles also achieved its stated objectives, although with some delays. The work on the Banking Law proved more time-consuming and resource-intensive than originally envisaged, due to the limited familiarity with applicable international standards, and the need to win support from a variety of stakeholders involved in the approval process of the new Law, which represented a drastic break from the past. The new Law was eventually approved in October 2019. This delay in the approval process led to a later start of the self-assessment, which was concluded in November.

RESULTS FRAMEWORK

FinSAC activities	FinSAC Outputs	Outcome	Outcome indicators	Baseline	Time horizon	Status
Ukraine – Analytical Tool for Assessing Consumer Lending						
Assist National Bank of Ukraine in developing analytical tools to assess systemic risk of rapid consumer lending.	Technical note describing the model. Training of National Bank staff.	Strengthened analytical capacity to support macroprudential policy-making.	Use of model results in National Bank Financial Stability Report and/or in internal reports to senior National Bank decision-makers.	Lack of quantitative models/benchmarks to assess equilibrium consumer credit growth, inability to provide evidence-based policy advice.	1 year after completion of technical assistance.	Fully achieved, within the expected time horizon.
Kosovo – Crisis Management and Strengthening Deposit Insurance Fund						
a) Documentation and analysis of key provisions of existing laws, regulations, policies and procedures of Central Bank of Kosovo relevant to handling financial crises. b) Policies and procedures for a quick solvency test to support Central Bank's lender of last resort functions. c) Documentation and analysis of Central Bank's existing strategies/procedures/practices for communications to and coordination with third parties. d) Recommendations on effective public communication during times of distress.	Notes summarizing main outcomes, and policy recommendations.	Strengthened Central Bank capacity to respond to financial distress effectively and timely.	Recommendations from the technical assistance followed up on. Client's perception of response capacity post-technical assistance.	Lack of operational readiness to respond to crises.	6 months post- technical assistance.	Fully achieved, but with a delay (project completion date extended).
Assist in the preparation of a crisis preparedness binder.	Note with recommended contents of crisis binder.	Strengthened Central Bank capacity to respond to financial distress effectively and timely.	Recommendations from the technical assistance followed up on Client's perception of response capacity post- technical assistance.	Lack of operational readiness to respond to a crisis situation.	6 months post- technical assistance.	Fully achieved, but with a delay (project completion date extended).
Review of the Deposit Insurance Fund/Central Bank memorandum of understanding.	Notes summarizing main outcomes, and policy recommendations.	Strengthening of Deposit Insurance Fund's operational readiness to quickly compensate eligible depositors, contributing to financial stability.	Any recommendations of the review followed up on.	Challenges in inter-agency coordination, cooperation, and information exchange.	6 months post-technical assistance.	Fully achieved, but with a delay (project completion date extended).

FinSAC activities	FinSAC Outputs	Outcome	Outcome indicators	Baseline	Time horizon	Status
Review of the premium calculation.		More robust premium calculation system, curbing moral hazard posed by high-risk banks.	Implement differential premium system in line with European Banking Authority guidelines.	Differential premium system not yet aligned with European Banking Authority guidelines.	1 year post-technical assistance.	Focus shifted to deposit insurance funding policy, (completion date extended).
Serbia – Strengthening the Foundations and Analytical Basis for the Deposit Insurance System						
Carry out an International Association of Deposit Insurers Core Principle assessment and develop a quantitative modeling of an appropriate target fund size.	Core Principle assessment. Target fund size model and summary note or presentation.	Stronger deposit insurance system and financial sector safety net.	Changes in legal framework related to deposit insurance to reflect outcomes.	Lack of objective assessment of Deposit Insurance Agency's capacity and heuristic estimate of target fund size.	1 year after start of technical assistance.	Fully achieved within the expected time horizon.
Uzbekistan – New Banking Law and Guided Basel Core Principles Self-Assessment						
Redrafting of the banking law.	New banking law, in line with international best practice.	Major upgrade of the legal framework for banking regulation and supervision.	New approved law.	Old banking law with severe deficiencies.	End-2018.	Fully achieved, but with a delay (project completion date extended).
Guided Basel Core Principles Self-Assessment.	A full assessment report, assessing compliance with the full set of Basel Core Principles, their constituent essential criteria, and preconditions. Action plan for three-years to address the gaps identified in a structured and prioritized manner.	Central Bank staff familiarized with the attributes of modern banking supervision. Central Bank staff and World Bank informed about the main gaps in the supervisory and regulatory framework, and supported with development of a reform direction for the next few years.	Outcomes of the self-assessment endorsed by Central Bank management. Central Bank staff familiar with Basel Core Principles methodology. Central Bank has a clear picture of reform agenda for bank supervision and regulation for the upcoming few years.	Central Bank staff mostly unfamiliar with attributes of modern banking supervisory function and unaware of the shortcomings of its supervisory and regulatory framework.	May 2019.	Fully achieved, but with a delay (project completion date extended).

SECTION 7:
A LOOK AHEAD TO 2020



This year's outlook has become highly uncertain due to the COVID-19 outbreak in the first quarter of 2020. The full magnitude and duration of the shock as well as its financial, fiscal, and social ramifications are still unclear as this annual report went to the press. The outbreak has prompted a series of emergency measures, including rate cuts, liquidity support, travel bans, mandatory closure of business, limitations on gatherings, to stem further spread, mitigate the disruption to economic activity, and avert a dislocation in financial markets. Major central banks have already issued decisive monetary and liquidity measures and announced coordinated action to support stressed global funding markets which are essential for the flow of credit to the real economy.

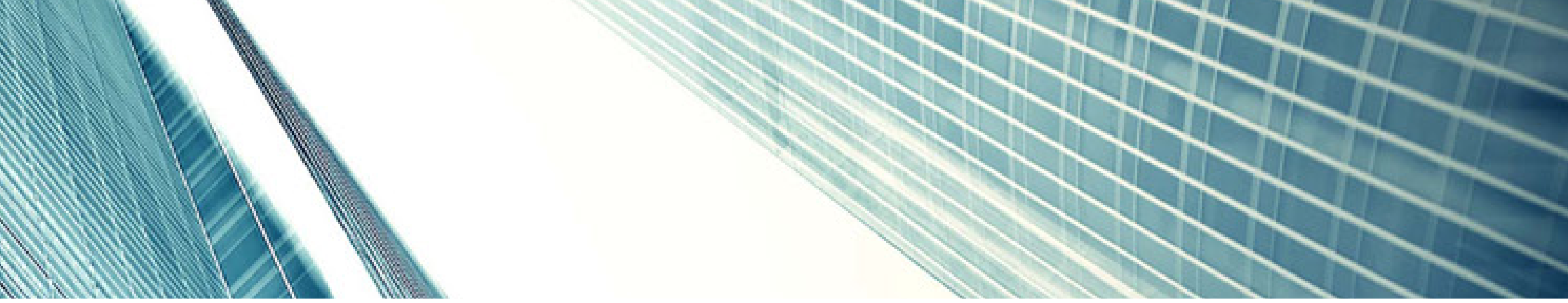
It is too early to fully assess the implications for FinSAC's work program. FinSAC remains committed to continue supporting client countries, but the combination of travel restrictions, and logistical challenges in undertaking technical assistance remotely has created a more challenging environment. Nonetheless, FinSAC stands ready to provide hands-on support to client countries to address the adverse financial stability challenges of COVID-19.

FinSAC started 2020 with a full work program, reflecting steadfast client country interest in financial stability. At the beginning of the year, it continued with the portfolio of seven activities (including four projects under the programmatic window) that had been initiated in 2018 and 2019 under FinSAC 3. In addition, several countries with standalone projects that were concluded end-2019 expressed strong interest in follow-up technical assistance. FinSAC has already set up and approved a follow-up project for Uzbekistan, while concept notes for new activities in Kosovo and Moldova are currently under preparation.

Bilateral technical assistance projects will continue to be the backbone of FinSAC's activities to the extent possible given COVID-19 restrictions. The hope is that these activities will be able to cover the full range of FinSAC's three pillar thematic structure. With four active projects under the programmatic window, FinSAC's focus is to bring these projects to a successful conclusion before initiating any further programmatic projects. New demand in the meantime will be met through standalone projects. In addition to its technical assistance portfolio, FinSAC continues with three active analytical projects and preparations are underway for an international flagship conference when the conditions allow this.

FinSAC's three pillars remain highly relevant for client countries. A significant part of client demand is driven by countries' intentions to align their legal, regulatory, and supervisory frameworks with international best practices that have been enhanced since the 2008 global financial crisis. This includes first and foremost the enhanced capital and liquidity requirements of Basel III and the upgraded bank resolution regimes as set out in the Key Attributes of Effective Resolution Regimes for Financial Institutions. Reform efforts in client countries in the Western Balkans are typically focused on achieving a high degree of convergence with the EU transposition of these international standards, notably CRD IV, CRR, and the BRRD.

FinSAC has been providing extensive support to client countries in these areas, but it remains a priority that more generic supervisory and regulatory topics receive the attention they deserve. In environments where the capacity to implement complex financial sector reforms is limited, client countries' focus on the post-crisis financial sector reform agenda has had the inevitable effect of taking some attention away from more basic prudential topics. This includes for instance frameworks for licensing and transfer of significant ownership and related party exposures. Although these topics have received

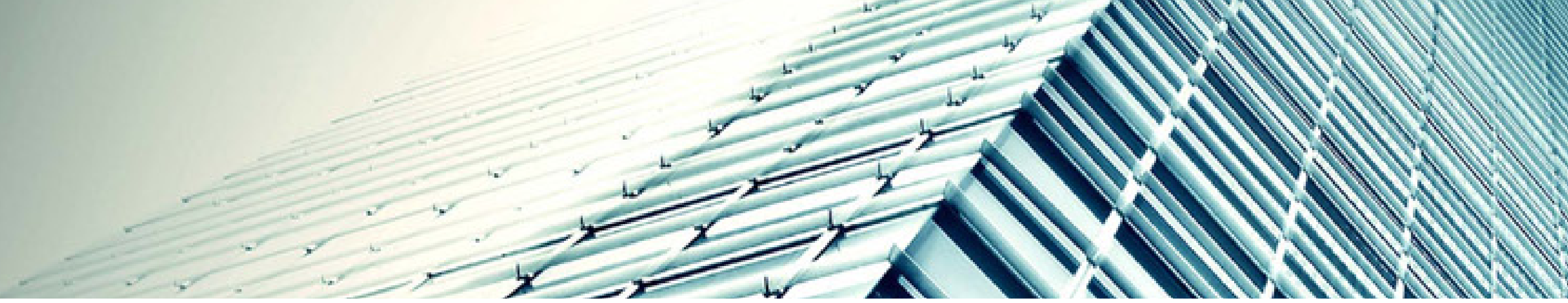


only limited attention in recent years, shortcomings in these areas are among the leading causes for banking crises, both in ECA region and beyond. These topics will be covered in detail in a forthcoming FinSAC study on related party lending, as well as at the 2020 FinSAC flagship conference. The conference will also discuss how the key tenets of the post-2008 crisis financial sector reform agenda can be implemented in a proportional manner, taking into consideration the overall lower stage of financial sector and market development. The expectation is that the conference will generate new opportunities for FinSAC to engage with client countries on the basics of prudential regulation and supervision. While FinSAC's product offerings are focused on a standard curriculum of stability-oriented topics, it is monitoring newly emerging themes with a view to a possible future engagement. FinSAC aims to build on the momentum initiated by its 2019 annual conference to further develop awareness of the implications of fintech for central bankers and prudential regulators. Promising areas could include the use of technologies to increase efficiency and effectiveness of regulatory and compliance requirements by the supervisor and/or regulator (i.e. regtech and suptech), as well as the regulation of so-called sandboxes. In addition, green finance has emerged as an area where FinSAC could potentially engage. Although green finance covers a broad range of areas including development of financial market instruments (e.g. green bonds), FinSAC could focus on prudential topics, such as quantitative tools to estimate the impact of greening the economy on banks' asset quality and methodologies for classifying economic sectors in function of their carbon footprint.

EXPECTED ACTIVITY WITHIN PILLAR 1 IN 2020: MACROPRUDENTIAL FRAMEWORKS, CRISIS PREPAREDNESS, AND DEPOSIT INSURANCE

Client country demand for support on cyber security for the financial sector is expected to remain strong, against the backdrop of a steady stream of high-profile cyber security incidents including in the financial sector. Among the threats are ransomware, the use of artificial intelligence-driven chatbots, and an increase in nation-state attacks. FinSAC will continue providing targeted support to client countries through cyber security-focused crisis simulation exercises and technical assistance on improving regulatory frameworks for mitigating cyber security risk in financial institutions. An internationally recognized set of best practices does not yet exist, so FinSAC's Digest of Cyber Security Regulations and Guidance will continue to serve as a reference point for technical assistance to client countries in this area. Using machine-based learning tools to compare regulations and guidelines with those of client countries FinSAC will continue to use the Digest to help identify gaps as well as significant conceptual departures.

Client countries continue to show strong interest in work related to strengthening deposit insurance. Particular areas of interest include assessments of the adequacy of deposit insurance coverage levels, the establishment of a target fund ratio for the "optimal" size of the deposit insurance fund, and methodologies for risk-based premiums. Several countries have also expressed an interest in FinSAC assistance in reinvigorating existing financial stability committees, which typically have responsibility for monitoring and mitigating systemic risk as well as the management of financial crises. Based on these experiences, FinSAC is preparing a paper that documents practices in the region regarding the set up and functioning of these committees, assessments of their effectiveness, and recommendations for their institutional design. Some of these committees have also expressed interest in support on quantitative tools for the identification of sources of systemic risk.



COVID-19 could lead to an increase in client country demand on work related to crisis preparedness and contingency planning. This work typically entails measures aimed at enhancing authorities' capacity to respond to episodes of financial distress, including problem bank identification and early intervention measures, enhancing the operational readiness of lender-of-last-resort facilities, and communication strategies in times of distress.

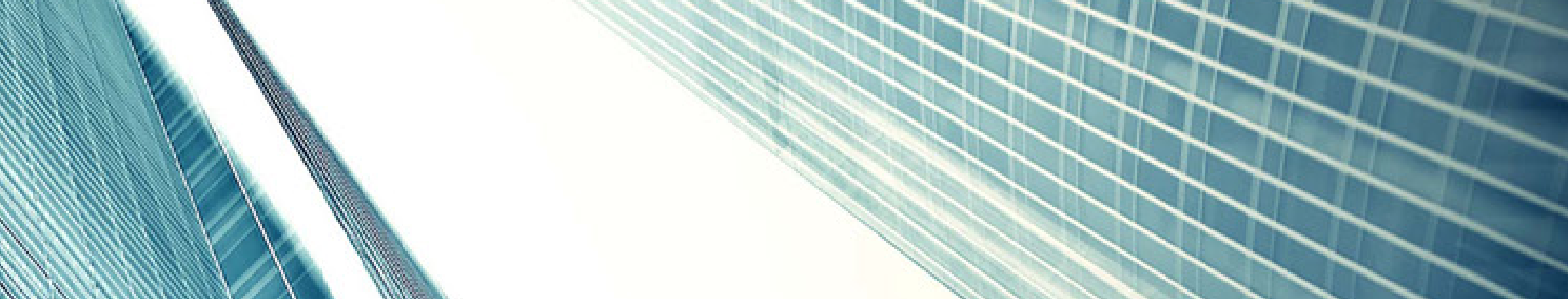
EXPECTED ACTIVITY WITHIN PILLAR 2 IN 2020: MICROPRUDENTIAL FRAMEWORKS AND NPL REDUCTION

Within pillar 2, recovery and resolution planning continues to attract a lot of client country interest. Most FinSAC client countries have revised their bank resolution laws and established dedicated bank resolution units. In most cases, banks have already prepared several rounds of recovery plans, in line with requirements stipulated by banking supervisors, while resolution units draft bank-specific resolution plans. Through FinSAC's technical assistance engagements in client countries in this area, it has become increasingly apparent that this process typically involves multiple iterations undertaken over several years. FinSAC will continue providing support to client countries in this area, with a special emphasis on those that are about to finalize revised bank resolution laws, e.g. Kosovo and North Macedonia. Prudential supervisors throughout the ECA region have been making efforts to introduce International Financial Reporting Standard (IFRS) 9, which requires banks to transition from provisioning based on incurred losses to expected losses. This approach is more forward-looking, but at the same time often also relies more on bank models to assess borrowers' repayment capacity. It is a key priority for FinSAC to enable bank supervisors to effectively challenge banks' estimates to preserve the integrity of bank-produced indicators of asset quality. In many countries, banking supervisors have opted to maintain prudential provisioning requirements, in parallel to the IFRS 9 accounting requirements. FinSAC will continue to provide support to client countries in this important area, including through the development of quantitative tools pioneered in North Macedonia.

Supervisors in the region are also moving from banks' risk assessment methodologies such as CAMELS to the EU's supervisory review and evaluation process. Building on the program completed in Bosnia and Herzegovina during 2019, FinSAC will advise other client countries on adapting supervisory policies and processes to EU aligned supervisory frameworks.

Although client countries in the region have been making notable progress in recent years in reducing NPL ratios, there are lingering questions regarding the sustainability of this reduction. This is due to the often weak financial condition of the largest corporate borrowers and a general scarcity of corporate restructuring to restore their commercial viability. FinSAC will be looking at opportunities to roll out analytical work aimed at assessing the health of the largest corporate borrowers across a broader set of countries.

Through its negative impact on economic activity, COVID-19 is expected to contribute to renewed pressures on asset quality in FinSAC client countries, which could bring the weak financial conditions of borrowers to the fore. To preserve economic activity, several countries have recently introduced special measures to provide relief to certain distressed borrowers, which typically involves a relaxation of loan classification and provisioning requirements. FinSAC stands ready to work with client countries on these asset quality challenges, including on the design of borrower relief strategies.



EXPECTED ACTIVITY WITHIN PILLAR 3 IN 2020: BANK RESOLUTION

FinSAC will continue supporting client countries in 2020 in establishing enhanced legal and regulatory frameworks for banking resolution, with a view to aligning resolution regimes with applicable best practices. The vast majority of client countries have put in place enhanced bank resolution regimes or are in the process of doing so within the foreseeable future. Some countries have indicated their interest in making further incremental changes to the legal framework for banking resolution, with a view to better tailoring the legal regime to the specificities of the local context. Nonetheless, the expectation is that FinSAC's work on bank resolution will become increasingly focused on supporting countries in operationalizing bank resolution arrangements, rather than legal reforms.

One of the critical issues remains the operationalization of bail-in of eligible creditors, which is a key feature of the BRRD. Given the overall early stage of financial market developments across FinSAC countries, the need for banks to maintain significant pools of high-quality liquid assets that can be bailed-in when banks are close to failure remains a challenging area. Absent such a pool of assets, uninsured deposits are often the only liability holders that can be bailed-in, which is politically highly contentious. The bank resolution case study, which was piloted in Romania with EU support in 2018, and the accompanying bail-in simulator are two recent additions to FinSAC's product offerings that can help policymakers in client countries in operationalizing the enhanced bank resolution frameworks. The bail-in simulator allows policymakers to quantify the effects of a bail-in on shareholders and different categories of creditors, while the bank resolution case study enables banking supervisors and resolution authorities to practice the handling of a bank failure in a simulated environment. Similar to a conventional crisis simulation exercise, the basic idea is to role play a scenario of banking distress, but with greater focus on resolution decisions than on interagency coordination of crisis measures.

FinSAC remains grateful to the Austrian Government for its ongoing support and looks forward to further fruitful collaborations with clients and partners in 2020 and beyond.

ANNEX 1: FINANCIAL STABILITY INDICATORS FINSAC COUNTRIES

Economy		Capital			Liquidity			Profitability	
		Regulatory capital / RWA	Tier 1 capital / RWA	Capital / total assets	Liquid assets / total assets	Liquid assets / short-term liabilities	Deposits / total noninterbank loans	Return on assets	Return on equity
European Union member states	Bulgaria	20.5	19.7	↑ 12.4	26.4	↓ 32.5	137.3	1.7	↑ 12.7
	Croatia	↑ 22.7	21.9	13.7	34.7	47.1	117.2	1.7	12.2
	Poland	18.4	16.3	9.7	↓ 15.8	27.6	95.3	0.6	7.6
	Romania	19.6	17.7	9.2	53.5	-	129.8	1.2	11.3
EU candidate and potential candidate countries	Albania	↑ 18.8	↑ 17.6	10.4	↑ 16.2	↑ 22.5	200.5	1.5	14.0
	Bosnia and Herzegovina	↑ 18.1	↑ 17.1	13.1	30.0	46.2	112.5	1.5	11.1
	Kosovo	17.0	15.2	12.1	27.7	37.0	123.9	2.3	18.4
	Montenegro	↑ 17.7	↑ 17.9	↑ 10.1	24.3	35.9	123.9	↑ 1.6	↑ 12.6
	North Macedonia	↑ 17.4	↑ 15.8	↑ 11.6	23.0	39.9	115.6	1.4	12.5
	Serbia	22.3	21.1	19.8	35.7	50.5	110.6	2.2	11.3
EU neighboring regions	Belarus	18.2	14.9	↑ 15.1	16.2	↑ -	90.9	2.0	13.2
	Moldova	26.0	25.7	↓ 13.1	51.5	-	167.9	↑ 3.3	↑ 18.7
	Ukraine	↑ 18.4	↑ 13.1	↑ 13.6	53.1	-	92.5	↑ 5.2	↑ 42.5
South Caucasus and Central Asia	Armenia	17.3	15.0	14.8	↓ 27.0	↓ -	107.5	1.4	9.7
	Georgia	↑ 19.0	↑ 14.4	12.0	22.9	28.3	81.2	2.4	18.9
	Uzbekistan	15.3	12.8	11.3	↓ 12.7	40.0	-	2.0	16.7

Economy		Exposures					
		NPLs net of provisions / capital	NPLs / total gross loans	Large exposures / capital	FX-denominated loans / total loans	FX-denominated liabilities / total liabilities	Net open FX position / capital
European Union member states	Bulgaria	↓ 23.3	7.3	↑ 90.7	35.0	38.0	0.2
	Croatia	7.2	↓ 7.6	52.5	57.3	55.1	3.4
	Poland	9.3	4.0	-	21.9	↓ 17.0	0.2
	Romania	11.9	4.7	59.6	33.4	30.8	1.7
EU candidate and potential candidate countries	Albania	15.2	10.2	↓ 88.9	↓ 51.0	51.2	8.0
	Bosnia and Herzegovina	10.2	7.7		↓ 53.8	51.2	5.9
	Kosovo	1.4	2.1	85.8	0.1	4.6	1.8
	Montenegro	3.5	5.3	↓ 113.2	0.4	↓ 5.3	0.5
	North Macedonia	-3.7	5.4	↑ 217.5	41.7	44.5	↓ 1.8
	Serbia	1.2	5.7	77.4	68.5	69.3	↑ 4.3
EU neighboring regions	Belarus	↓ 18.4	↓ 5.8	163.5	↓ 48.5	↓ 63.2	5.3
	Moldova	10.5	↓ 10.6	26.4	↓ 35.0	43.7	-8.0
	Ukraine	↓ 31.5	48.9	↓ 120.8	41.6	↓ 44.4	-
South Caucasus and Central Asia	Armenia	11.9	5.5	142.4	↓ 52.4	↓ 56.8	-1.4
	Georgia	6.8	2.6	.	55.0	63.0	↓ -1.8
	Uzbekistan	5.0	1.5	.	.	.	4.4

Source: IMF Financial Soundness Indicators, National Bank of Serbia, and Central Bank of Montenegro.

Note: The statistics, represented in percentages, are prepared using information available at March 15, 2020. They typically reflect conditions of financial systems as of September 2019. December 2019 data is used for Albania, Georgia, Montenegro, and Ukraine. The background colors of indicators represent their rankings among the countries, with deeper blue reflecting more favorable positions and deeper red less favorable. The arrows left of values indicate changes beyond one historical standard deviation away from the most recent three-year averages. The icons on the right illustrate indicator evolutions over a 10-year timespan. Underlines indicate calculations for countries that unilaterally adopted the euro (Kosovo and Montenegro) as their domestic currency. "." and "-" respectively indicate cases where reported values were missing or censored.

ANNEX 2: DISBURSEMENT OF TRUST FUND BY FINSAC

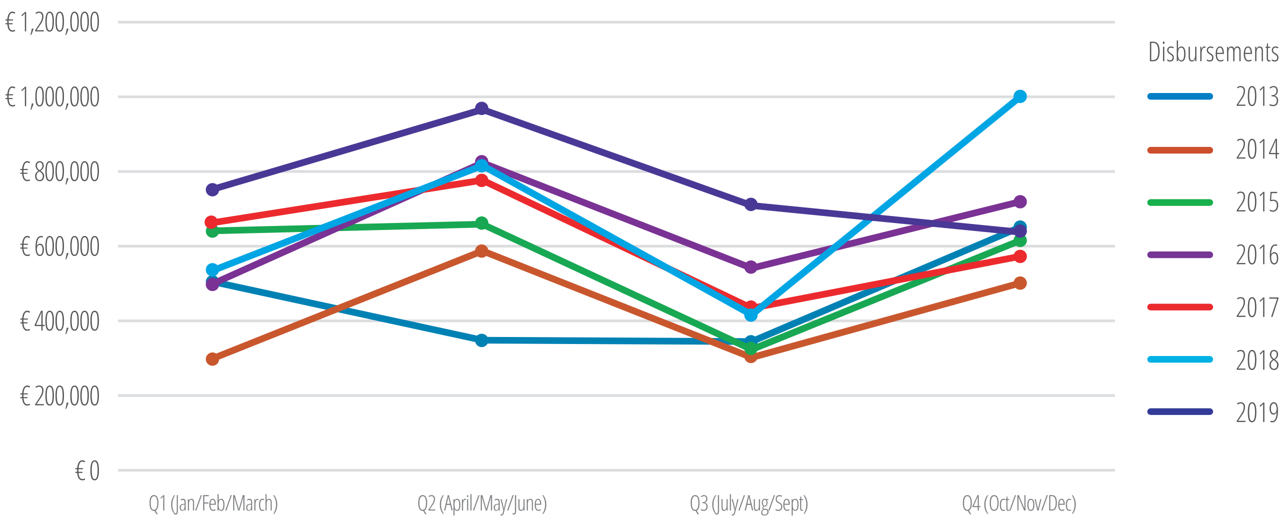
As of January 1, 2020

FINSAC 2 (TF071659 – completed disbursement on December 31, 2019)	
Contributions paid-in	€ 13,177,200.00
Investment Income	€ 86,041.95
Admin fee (incl. start-up fee)	€ 658,860.00
Disbursements	€ 12,578,075.47
Refund to donor	€ 1,805.25
Fund Balance	**€ 0.00**

FINSAC 2 (parallel TF072761 – completed disbursement on December 31, 2019)	
Contributions paid-in	€ 2,000,000.00
Investment Income*	€ (10,075.86)
Disbursements	€ 1,989,692.23
Refund to donor	€ 231.87
Fund Balance	**€ 0.04**

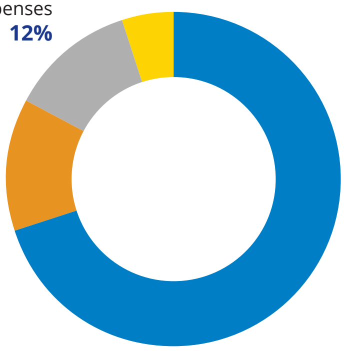
FINSAC 3 (TF072993 – disbursement end date is June 31, 2023)	
Contributions paid-in	€ 6,000,000.00
Contributions to be paid	€ 2,000,000.00
Investment Income*	€ (31,894.43)
Disbursements	€ 3,200,297.39
Fund Balance incl. commitments	**€ 2,767,808.18**

	Disbursements						
	2013	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**[i]
Q1	€ 503,296	€ 295,836	€ 638,483	€ 495,853	€ 660,469	€ 533,788	€ 749,983
Q2	€ 346,791	€ 585,282	€ 659,242	€ 823,747	€ 775,256	€ 814,793	€ 965,546
Q3	€ 343,023	€ 301,968	€ 323,288	€ 540,713	€ 433,911	€ 414,172	€ 708,361
Q4	€ 649,640	€ 499,193	€ 613,310	€ 718,554	€ 572,154	€ 1,000,471	€ 637,033
Total	**€ 1,842,749**	**€ 1,682,278**	**€ 2,234,323**	**€ 2,578,867**	**€ 2,441,790**	**€ 2,763,224**	**€ 3,060,923**

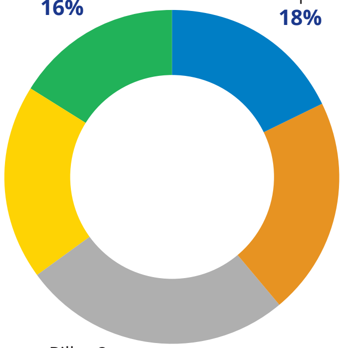


* Due to negative savings rate in EUR.
i Including FinSAC 2 & 3 TFs

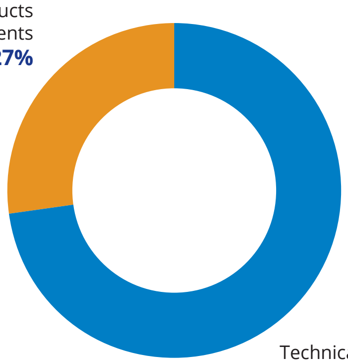
Disbursement by categories (for the period of January 1, 2019 – December 31, 2019)		
Staff costs[2]	€ 2,143,342	70%
Consultant fees[3]	€ 397,709	13%
Travel expenses[4]	€ 367,801	12%
Publications & workshop/meetings	€ 152,071	5%
Fund Balance	**€ 3,060,923**	**100%**



Disbursement by pillars (for the period of January 1, 2019 – December 31, 2019)		
Administrative expenses[5]	€ 540,277	18%
Pillar 1: Financial stability, macro-prudential supervision, and crisis management	€ 647,974	21%
Pillar 2: Microprudential oversight, recovery planning, and NPL resolution	€ 812,520	26%
Pillar 3: Banking resolution including liquidation	€ 568,514	19%
Programmatic	€ 491,638	16%
Fund Balance	**€ 3,060,923**	**100%**

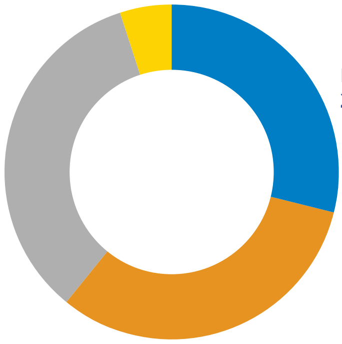


Disbursement by output (for the period of January 1, 2019 – December 31, 2019)		
Technical assistance (TA) delivery	€ 1,828,788	73%
Knowledge products & events	€ 691,858	27%
Total (excl admin expenses)	€ 2,520,646	100%



2 Incl. FinSAC Coordinator, one program assistant, seven TTLs and related unit TTLs supporting FinSAC program
3 Incl. short term consultants and consultant firms
4 Incl. travel expenses of staff and consultants/visitors
5 Incl. cost of all types of categories not related to specific trust fund activities and all general expenses: program management, content management and design, staff cost of program assistant/back up, travel cost for staff for training, general translation services, utilities, office maintenance, office supplies, depreciation, publications and other printing services, representation cost, coordination, and some business development activities

Disbursement by country groups (for the period of January 1, 2019 –December 31, 2019)		
Regional	€ 731,557	29%
EU Candidates & Potential Candidate countries (Albania, BiH, Kosovo, North Macedonia, Montenegro, Serbia)	€ 793,109	32%
EU Neighboring countries (Belarus, Georgia, Moldova, Ukraine)	€ 858,254	34%
Central Asia (Uzbekistan)	€ 137,726	5%
Total (excl admin expenses)	**€ 2,520,646**	**100%**



Disbursement by countries (for the period of January 1, 2019 – December 31, 2019)		
Regional	€ 731,557	29%
Albania	€ 90,037	4%
Belarus	€ 144,690	6%
BiH	€ 187,641	7%
Georgia	€ 282,921	11%
Kosovo	€ 161,504	6%
North Macedonia	€ 176,472	7%
Moldova	€ 59,790	2%
Montenegro	€ 18,781	1%
Serbia	€ 158,675	6%
Ukraine	€ 370,854	15%
Uzbekistan	€ 137,726	6%
Total (excl admin expenses)	**€ 2,520,646**	**100%**

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