Combined Project Information Documents / Integrated Safeguards Datasheet (PID/ISDS)

Appraisal Stage | Date Prepared/Updated: 28-Feb-2017 | Report No: PIDISDSA19449

BASIC INFORMATION

A. Basic Project Data

Country	Project ID	Project Name	Parent Project ID (if any)
Bosnia and Herzegovina	P158387	Banking Sector Strengthening Project	
Region	**Estimated Appraisal Date**	**Estimated Board Date**	**Practice Area (Lead)**
EUROPE AND CENTRAL ASIA	23-Feb-2017	28-Apr-2017	Finance & Markets
Lending Instrument	**Borrower(s)**	**Implementing Agency**	
Investment Project Financing	BiH Ministry of Finance and Treasury	Republika Srpska Ministry of Finance, FBiH Ministry of Finance	

Proposed Development Objective(s)

The Project Development Objective (PDO) is to improve the soundness of the banking sector in BiH by enhancing bank regulation, supervision and resolution capacity and enhancing governance of entity development banks.

Components

Banking Sector Strengthening

Financing (in USD Million)

Financing Source	Amount
International Bank for Reconstruction and Development	60.00
Total Project Cost	**60.00**

Environmental Assessment Category

C - Not Required

Decision

The review did authorize the preparation to continue

Other Decision (as needed)

B. Introduction and Context

Country Context

1. **After modest post-crisis recovery, Bosnia and Herzegovina (BiH) continues to struggle with structural problems that undermine economic growth.** Following the global financial crisis (2008/2009) and subsequent Eurozone crisis leading to a double-dip contraction of the economy, the country experienced the beginning of a moderate economic recovery in 2013 when growth reached 2.4 percent. This was interrupted by the floods of May 2014 which impacted almost all sectors of the economy and slowed growth to 1.1 percent in 2014. Following the floods of 2014, and supported by stronger net external demand, the economy recovered in 2015 achieving growth of 3.0 percent. At the same time, the current account balance narrowed down from -7.5 percent of gross domestic product (GDP) in 2014 to -5.5 percent of GDP in 2015 primarily on the back of weaker imports, with lower oil prices bringing down imports of related products. The fiscal deficit is foreseen to further narrow and stay below 1 percent of GDP in 2016 with some key structural rigidities (wage freeze and better targeted social assistance) in public expenditures addressed. However, despite some improvements, the private sector is still hampered by a lackluster business environment, high labor taxes, inflexible labor market policies, uneven transport infrastructure, energy inefficiency and other constraints. Meanwhile, high unemployment at around 25.4 percent, especially among youth, and low productivity of capital are among the factors that constrain income growth in the medium-term.

Sectoral and Institutional Context

2. **The BiH banking sector dominates the financial sector and is primarily foreign owned.** There are 23 banks in BiH accounting for around 87 percent of financial system assets, which are equivalent to 85 percent of GDP as of end-2015. The banking system comprises mostly foreign subsidiaries—91 percent of the banking sector assets while domestically-owned and state-owned banks account for 7 and 2 percent respectively. The five largest banks represented about half of banking sector assets in 2015. The number of banks operating in BiH remains high relative to peer countries with room for further consolidation.

3. **The banking sector is still dealing with the aftershocks of the global financial crisis that have weakened financial sector asset quality and profitability.** Following credit growth of an annual average of 20 percent between 2004 and 2008, private sector credit growth turned negative at the end of 2009 and since then has grown at an annual rate of only 2-3 percent. The system-wide non-performing loan (NPL) ratio – although on a slightly declining trend – remained high at 12.1 percent in Q3 2016, reflecting the impacts of the financial crisis, lax credit practices, and weak debt recovery mechanisms which hamper banks' efforts to work out NPLs. Profitability has been slightly improving with return on equity (ROE) and return on assets (ROA) standing at 7.1 and 0.9 percent respectively. Although capital adequacy ratio (CAR) is above the regulatory minimum of 12 percent (at 16.1 percent in Q3 2016), there exist wide variations between banks. While Federation BiH Development Bank (RBFBiH) and Republika Srpska (RS) Investment Development Bank (IRBRS) differ in terms of operations conducted and their size, they face significant weaknesses with regard to their institutional and governance arrangements and are both subject to political interference.

4. **Against this backdrop, it is essential that the financial safety net is further strengthened by developing a comprehensive resolution regime to deal with the weakest banks either through**

recovery or resolution/liquidation. A number of key elements in the financial safety arrangements are either missing or not adequately developed. Banking regulation and supervision have improved during the last decade, but a number of important shortcomings remain. Lack of adequate governance and risk management has contributed to the current number of problem banks. Fragmentation of the institutional framework and the lack of coordination and information sharing between stakeholders are delaying needed reforms and improvements, and result in duplications of effort that waste scarce supervisory resources. The development banks require operational and institutional reform to avoid distortive impacts on the banking sector and facilitate sound corporate governance.

C. Proposed Development Objective(s)

Development Objective(s) (From PAD)

The Project Development Objective (PDO) is to improve the soundness of the banking sector in BiH by enhancing bank regulation, supervision and resolution capacity and enhancing governance of entity development banks.

Key Results

5. **The PDO level indicators (PDIs) include the following:**

PDI 1

a) All banks remain well-capitalized (defined as capital adequacy ratio for each bank in BiH being above the regulatory minimum)

b) Banking agencies review and efficiently respond to cases when banks do not meet prudential norms for capital adequacy and liquidity. Efficiently means the supervisor takes action within 90 days of a bank violating prudential norms for capital adequacy and liquidity.

PDI 2

Banking agencies performing their legally mandated technical functions in bank resolution, including in any future bank failure.

PDI 3

New governance and business model for entity development banks adopted.

6. **These PDO level indicators are underpinned by a series of disbursement linked indicators (DLIs) that will be utilized to achieve these results**.

D. Project Description

7. **The Project Development Objective will be addressed through supporting the authorities in strengthening of the country's banking sector in a sound, stable and inclusive manner**. The project will accomplish this by improving bank regulation and supervision, addressing weaknesses in the banking sector, establishing the new bank resolution framework and enhancing governance and operation of the entity development banks.

8. **The project design is uniquely tailored to ensure that activities proposed for the banking sector are fully harmonized between the entities, creating a uniform environment for banking sector operation**. In a fragmented environment this design provides stability, transparency and predictability for banks and supervisors alike, creating a more stable and resilient financial sector benefiting businesses and citizens.

9. **The Project will follow the results-based format with WB financing made available to the entity MoFs in several tranches based on the achievement of a set of disbursement linked indicators**. Substantial technical assistance is needed to support the authorities to achieve the goals set forth in the program. This will to a large extent be provided by the WB with trust fund assistance but may need to be complemented with further investments in technical assistance to ensure sustainable outcomes.

10. **The project builds around five components that focus on strengthening the banking sector through improving bank regulation and supervision, addressing weaknesses in the banking sector, establishing a bank resolution framework and enhancing governance and operations of the entity development banks**. It aims to support the authorities' implementation of key financial sector reforms identified in the medium term Reform Agenda, in the Banking agencies' FSAP implementation action plans, and in specific requests for assistance from the WB.

Component 1: Strengthening regulation and supervision aligned with Basel II/III

11. **Component 1 focuses on strengthening banking sector regulation and supervision aligned with Basel II/III regimes**. As part of this results area, the project will support the banking agencies in further strengthening capital and liquidity requirements to enhance banks' ability to withstand solvency and liquidity shocks. In support of the so-called Pillar 2 implementation - which aims to enhance the link between an institution's risk profile, its risk management and its capital planning – results area 1 supports the introduction of a risk appetite framework and internal capital adequacy assessment process (ICAAP). This will form the basis for a revised supervisory risk-based methodology aligned with the EU framework aimed at enhancing transparency and harmonization of supervisory review processes.

Component 2: Addressing weaknesses in the banking sector

12. **Component 2 focuses on addressing weaknesses in the banking sector.** As part of the results area, the project seeks to support the enhancement of the terms of reference for asset quality reviews (AQRs), the launch of the 2017 AQRs of twelve remaining banks and enforcement of the results of those AQRs either by mandatory time bound corrective action programs or resolution/liquidation programs for all undercapitalized banks.

Component 3: Operationalizing the new bank resolution framework

13. **As part of Component 3, the project will support the authorities in implementation of the bank resolution framework as foreseen in the Banking Laws**. The DLIs focus on preparation and adoption of a key set of bylaws and decisions related to bank recovery and resolution, establishment and operationalization of dedicated bank resolution units within the banking agencies, adoption of an internal assessment methodology for recovery plans and subsequent assessment of recovery plans to be submitted by all banks.

Component 4: Improving governance and business models of entity development banks

14. **Component 4 supports strengthening of institutional, corporate governance and supervisory arrangements of the entity development banks**. The DLIs address specific steps to be taken in defining the strategic vision that will restructure the banks' balance sheets, guide the development banks' institutional strengthening, development of a business plan focusing on its implementation, enhancing corporate governance arrangements and alignment of development banks' regulatory and supervisory framework with those required for FBA/BARS-regulated banks.

Component 5: Technical assistance

15. **While the Bank will provide critical technical assistance for supporting the implementation of this project via complementary trust fund assistance, the volume of work that is ahead of the authorities is significant.** The level of engagement needed to support implementation of the DLIs requires substantial technical assistance and may go beyond that secured by the WB. A small portion of the loan is therefore set aside for technical assistance and operational costs.

E. Implementation

Institutional and Implementation Arrangements

16. **There will be small project implementation teams (PIT) at each entity Ministry of Finance (MoF).** The Borrower is the Ministry of Finance and Treasury (MoFT) which will make the respective portions of the loan proceeds available to the entity MoFs through Subsidiary Loan Agreements. In addition, focal points will be appointed at each of the banking agencies and the entity development banks to complement the PITs.

17. **The implementation arrangements for both loans are expected to be fairly straightforward as the WB funds will be used applying the results-based financing instrument, and there will be a set number of disbursements against DLIs.** The entity MoFs will house the project and the PITs will be responsible for monitoring of implementation, execution of TA procurement, should there be one, and reporting to the WB. The MoFs will be asked to ensure that they maintain adequate governance and fiduciary arrangements throughout the project implementation period.

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F. Project location and Salient physical characteristics relevant to the safeguard analysis (if known)

G. Environmental and Social Safeguards Specialists on the Team

Esma Kreso,Ifeta Smajic

SAFEGUARD POLICIES THAT MIGHT APPLY

Safeguard Policies	Triggered?	Explanation (Optional)
Environmental Assessment OP/BP 4.01	No	The scope of the Project does not include any physical works or activities that may impact the environment. Furthermore, any activities proposed under the assistance of the Project will not result in civil works, reconstruction, renovation or new construction. The policies are related solely to the banking sector and should have no repercussions on the environment or natural resources.
Natural Habitats OP/BP 4.04	No	
Forests OP/BP 4.36	No	
Pest Management OP 4.09	No	
Physical Cultural Resources OP/BP 4.11	No	
Indigenous Peoples OP/BP 4.10	No	
Involuntary Resettlement OP/BP 4.12	No	There will be no land acquisition within the project.
Safety of Dams OP/BP 4.37	No	
Projects on International Waterways OP/BP 7.50	No	
Projects in Disputed Areas OP/BP 7.60	No	

KEY SAFEGUARD POLICY ISSUES AND THEIR MANAGEMENT

A. Summary of Key Safeguard Issues

1. Describe any safeguard issues and impacts associated with the proposed project. Identify and describe any potential large scale, significant and/or irreversible impacts:

2. Describe any potential indirect and/or long term impacts due to anticipated future activities in the project area:

3. Describe any project alternatives (if relevant) considered to help avoid or minimize adverse impacts.

4. Describe measures taken by the borrower to address safeguard policy issues. Provide an assessment of borrower capacity to plan and implement the measures described.

5. Identify the key stakeholders and describe the mechanisms for consultation and disclosure on safeguard policies, with an emphasis on potentially affected people.

B. Disclosure Requirements

C. Compliance Monitoring Indicators at the Corporate Level (to be filled in when the ISDS is finalized by the project decision meeting)

The World Bank Policy on Disclosure of Information

Have relevant safeguard policies documents been sent to the World Bank's Infoshop?
NA

Have relevant documents been disclosed in-country in a public place in a form and language that are understandable and accessible to project-affected groups and local NGOs?
NA

All Safeguard Policies

Have satisfactory calendar, budget and clear institutional responsibilities been prepared for the implementation of measures related to safeguard policies?
NA

Have costs related to safeguard policy measures been included in the project cost?
NA

Does the Monitoring and Evaluation system of the project include the monitoring of safeguard impacts and measures related to safeguard policies?
NA

Have satisfactory implementation arrangements been agreed with the borrower and the same been adequately reflected in the project legal documents?
NA

CONTACT POINT

World Bank

Johanna Jaeger
Senior Financial Sector Specialist

Ruvejda Aliefendic
Senior Private Sector Specialist

Borrower/Client/Recipient

BiH Ministry of Finance and Treasury

Implementing Agencies

Republika Srpska Ministry of Finance
Zoran Tegeltija
Minister of Finance
mf@mf.vladars.net

FBiH Ministry of Finance
Jelka Milićević
Minister of Finance FBiH
info@fmf.gov.ba

FOR MORE INFORMATION CONTACT

The World Bank
1818 H Street, NW
Washington, D.C. 20433
Telephone: (202) 473-1000
Web: http://www.worldbank.org/projects

APPROVAL

Task Team Leader(s):	Johanna Jaeger Ruvejda Aliefendic

Approved By

Safeguards Advisor:	Mario Guadamillas	28-Feb-2017
Practice Manager/Manager:	Brett E. Coleman	28-Feb-2017
Country Director:	Tatiana A. Proskuryakova	28-Feb-2017