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R2017-0094/1

April 11, 2017

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<p><b>Closing Date: Friday, April 28, 2017 at 6 p.m.</b></p>
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FROM: Vice President and Corporate Secretary

**Bosnia and Herzegovina – Banking Sector Strengthening Project**

**Project Appraisal Document**

Attached is the Project Appraisal Document regarding a proposed loan to Bosnia and Herzegovina for a Banking Sector Strengthening Project (R2017-0094), which is being processed on an absence-of-objection basis.

Distribution:

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Report No: PAD2000

INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

PROJECT APPRAISAL DOCUMENT

ON A

PROPOSED LOAN

IN THE AMOUNT OF EUR 56.6 MILLION

TO THE

BOSNIA AND HERZEGOVINA

FOR A

BANKING SECTOR STRENGTHENING PROJECT

April 7, 2017

Finance & Markets Global Practice  
Europe And Central Asia Region

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## CURRENCY EQUIVALENTS

(Exchange Rate Effective Feb 28, 2017)

Currency Unit = Euro (EUR)

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BAM 1 = EUR 0.51129

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EUR 1 = BAM 1.95583

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USD 1 = EUR 0.943129

## FISCAL YEAR

January 1 - December 31

Regional Vice President: Cyril E Muller

Country Director: Ellen A. Goldstein

Senior Global Practice Director: Ceyla Pazarbasioglu-Dutz

Practice Manager: Mario Guadamillas

Task Team Leader(s): Johanna Jaeger, Ruvejda Aliefendic

## ABBREVIATIONS AND ACRONYMS

AQR	Asset Quality Review
BA	Banking Agency
BAM	Bosnia and Herzegovina Convertible Marka
BARS	Banking Agency of the Republika Srpska
BB	BOR Banka
BiH	Bosnia and Herzegovina
BIS	Bank for International Settlements
BRRD	Bank Recovery and Resolution Directive
CAR	Capital Adequacy Ratio
CBBH	Central Bank of Bosnia and Herzegovina
CPF	Country Partnership Framework
DB	Development Bank
DFI	Development Finance Institution
DIA	Deposit Insurance Agency
DIF	Deposit Insurance Fund
DLI	Disbursement Linked Indicator
DLR	Disbursement Linked Results
DPL	Development Policy Loan
EBA	European Banking Authority
EBRD	European Bank for Reconstruction and Development
EEP	Eligible Expenditure Program
EFF	Extended Fund Facility
EU	European Union
FBA	Federal Banking Agency
FBiH	Federation of Bosna and Herzegovina
FinSAC	Financial Sector Advisory Center of the World Bank
FM	Financial Management
FSAP	Financial Sector Assessment Program
GDP	Gross Domestic Product
GRS	World Bank's Grievance Redress Service
IA	Implementing Agency
IBRD	International Bank for Reconstruction and Development
ICAAP	Internal Capital Adequacy Assessment Process
IFC	International Finance Corporation
IFI	International Financial Institution
IFR	Interim Financial Report
IFRS	International Financial Reporting Standards
IMF	International Monetary Fund
IRBRS	Investment Development Bank of the Republika Srpska
KM	Bosnia and Herzegovina Convertible Marka
MoF	Ministry of Finance
MoFT	Ministry of Finance and Treasury

MOU	Memorandum of Understanding
MREL	Minimum Requirement for Own Funds and Eligible Liabilities
NPL(s)	Nonperforming Loans
PBS	Privredna Banka Sarajevo
PforR	Program-for-Results
PDO	Project Development Objective
PIT	Project Implementation Team
POM	Project Operations Manual
PP	Procurement Plan
QIS	Quantitative Impact Study
RFBiH	Development Bank of the Federation of Bosnia and Herzegovina
ROA	Return on Assets
ROE	Return on Equity
RS	Republika Srpska
SCFS	Standing Committee on Financial Stability
SME	Small and Medium-sized Enterprise
SOE	Statement of Expenditure
SORT	Systematic Operations Risk-Rating Tool
SREP	Supervisory Review and Evaluation Process
UK	United Kingdom
USAID	United States Agency for International Development
WB	World Bank



**BASIC INFORMATION**

Is this a regionally tagged project? No	Country(ies)	Lending Instrument Investment Project Financing
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- Situations of Urgent Need of Assistance or Capacity Constraints
- Financial Intermediaries
- Series of Projects

Approval Date 28-Apr-2017	Closing Date 31-Dec-2019	Environmental Assessment Category C - Not Required
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Bank/IFC Collaboration No
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**Proposed Development Objective(s)**

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

**Components**

Component Name	Cost (US\$, millions)
Banking Sector Strengthening	60.00

**Organizations**

Borrower : BiH Ministry of Finance and Treasury

Implementing Agency : Republika Srpska Ministry of Finance  
FBiH Ministry of Finance

<input type="checkbox"/>	<input checked="" type="checkbox"/> IBRD	<input type="checkbox"/> IDA Credit	<input type="checkbox"/> IDA Grant	<input type="checkbox"/> Trust	<input type="checkbox"/>
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Counterpart Funding		<input type="checkbox"/> Crisis Response Window	<input type="checkbox"/> Crisis Response Window	Funds	Parallel Financing
		<input type="checkbox"/> Regional Projects Window	<input type="checkbox"/> Regional Projects Window		
Total Project Cost:		Total Financing:		Financing Gap:	
60.00		60.00		0.00	
		Of Which Bank Financing (IBRD/IDA):			
		60.00			

**Financing (in US\$, millions)**

Financing Source	Amount
IBRD-87410	60.00
<b>Total</b>	<b>60.00</b>

**Expected Disbursements (in US\$, millions)**

Fiscal Year	2017	2018	2019	2020	2021
Annual	0.24	5.82	12.81	26.36	14.78
Cumulative	0.24	6.05	18.86	45.22	60.00

**INSTITUTIONAL DATA****Practice Area (Lead)**

Finance &amp; Markets

**Contributing Practice Areas**



**Gender Tag**

Does the project plan to undertake any of the following?

a. Analysis to identify Project-relevant gaps between males and females, especially in light of country gaps identified through SCD and CPF

Yes

b. Specific action(s) to address the gender gaps identified in (a) and/or to improve women or men's empowerment

No

c. Include Indicators in results framework to monitor outcomes from actions identified in (b)

No

**SYSTEMATIC OPERATIONS RISK-RATING TOOL (SORT)**

Risk Category	Rating
1. Political and Governance	● Substantial
2. Macroeconomic	● Moderate
3. Sector Strategies and Policies	● Moderate
4. Technical Design of Project or Program	● Substantial
5. Institutional Capacity for Implementation and Sustainability	● Substantial
6. Fiduciary	● Moderate
7. Environment and Social	● Low
8. Stakeholders	● Moderate
9. Other	
10. Overall	● Substantial

**COMPLIANCE**

**Policy**

Does the project depart from the CPF in content or in other significant respects?

Yes  No



Does the project require any waivers of Bank policies?

[ ] Yes [✓] No

**Safeguard Policies Triggered by the Project**

Yes No

Environmental Assessment OP/BP 4.01

✓

Natural Habitats OP/BP 4.04

✓

Forests OP/BP 4.36

✓

Pest Management OP 4.09

✓

Physical Cultural Resources OP/BP 4.11

✓

Indigenous Peoples OP/BP 4.10

✓

Involuntary Resettlement OP/BP 4.12

✓

Safety of Dams OP/BP 4.37

✓

Projects on International Waterways OP/BP 7.50

✓

Projects in Disputed Areas OP/BP 7.60

✓

**Legal Covenants**

Sections and Description

Title: Implementation Agreements. Description: No later than three months after the Effective Date, each Project Implementing Entity shall enter into separate agreements with its banking agency and development bank under terms and conditions acceptable to the Bank.

**Conditions**

Type  
Effectiveness

Description

The Subsidiary Agreement has been executed on behalf of the Borrower and an Entity.

Type  
Effectiveness

Description

The project implementation team (PIT) for the Entity referred to in paragraph (a) of Section 5.01 of the Loan Agreement has been established with composition, functions and resources acceptable to the Bank.

Type  
Effectiveness

Description

The Project Operations Manual for the Entity referred to in paragraph (a) of



	Section 5.01 of the Loan Agreement has been adopted by that Entity, in a manner and with contents acceptable to the Bank.
Type Disbursement	Description No withdrawal shall be made under Categories (1) and (2) unless: the FBiH Project Agreement has been executed, the FBiH Subsidiary Agreement has been executed; the related legal opinion or opinions have been furnished to the Bank; the FBiH PIT has been established; and the FBiH Banking Laws have been approved and duly published.
Type Disbursement	Description No withdrawal shall be made under Categories (3) and (4) unless: the RS Project Agreement has been executed, the RS Subsidiary Agreement has been executed; the related legal opinion or opinions have been furnished to the Bank; and the RS PIT has been established.

**PROJECT TEAM****Bank Staff**

Name	Role	Specialization	Unit
Johanna Jaeger	Team Leader(ADM Responsible)	Senior Financial Sector Specialist	GFM03
Rujejda Aliefendic	Team Leader	Senior Private Sector Specialist	GTC03
Karina Mostipan	Procurement Specialist(ADM Responsible)	Senior Procurment Specialist	GGO03
Lamija Marijanovic	Financial Management Specialist	Senior Financial Management Specialist	GGO21
Alena Kantarovich	Team Member	Financial Analyst	GFM03
Esmā Kreso	Safeguards Specialist	Senior Environmental Specialist	GEN03
Gabriela Grinsteins	Counsel	Counsel	LEGLE
Hermanus Johannes Marc Schrijver	Team Member		GFM09
Ifeta Smajic	Safeguards Specialist	Safeguards	GSU03
Jan Philipp Nolte	Team Member	Senior Financial Sector Specialist	GFM1A
Luis M. Schwarz	Team Member	Senior Finance Officer	WFALN
Pamela Lintner	Team Member	Senior Financial Sector	GFM03



Specialist

Sandra Hlivnjak	Team Member	Economist	GMF12
Zumreta Susic	Team Member		ECCBM

Extended Team

Name	Title	Organization	Location
Andrew Lovegrove	Senior Banking Consultant		
Ismael Ahmad	Senior Banking Consultant		
Janine Thorne	Consultant (DFI Governance)		

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BOSNIA AND HERZEGOVINA  
BANKING SECTOR STRENGTHENING PROJECT

**TABLE OF CONTENTS**

<b>I. STRATEGIC CONTEXT .....</b>	<b>1</b>
<b>A. Country Context .....</b>	<b>1</b>
<b>B. Sectoral and Institutional Context .....</b>	<b>2</b>
<b>C. Higher Level Objectives to which the Project Contributes .....</b>	<b>8</b>
<b>II. PROJECT DEVELOPMENT OBJECTIVES.....</b>	<b>8</b>
<b>A. PDO .....</b>	<b>8</b>
<b>B. Project Beneficiaries.....</b>	<b>9</b>
<b>C. PDO-Level Results Indicators .....</b>	<b>9</b>
<b>III. PROJECT DESCRIPTION.....</b>	<b>9</b>
<b>A. Project Components.....</b>	<b>9</b>
<b>B. Project Cost and Financing.....</b>	<b>12</b>
<b>C. Lessons Learned and Reflected in the Project Design.....</b>	<b>13</b>
<b>IV. IMPLEMENTATION.....</b>	<b>15</b>
<b>A. Institutional and Implementation Arrangements.....</b>	<b>15</b>
<b>B. Results Monitoring and Evaluation .....</b>	<b>15</b>
<b>C. Sustainability .....</b>	<b>15</b>
<b>D. Role of Partners.....</b>	<b>16</b>
<b>V. KEY RISKS .....</b>	<b>17</b>
<b>A. Overall Risk Rating and Explanation of Key Risks .....</b>	<b>17</b>
<b>VI. APPRAISAL SUMMARY.....</b>	<b>19</b>
<b>A. Economic and Financial (if applicable) Analysis.....</b>	<b>19</b>
<b>B. Technical .....</b>	<b>20</b>
<b>C. Financial Management .....</b>	<b>23</b>
<b>D. Procurement.....</b>	<b>24</b>
<b>E. Social (including Safeguards).....</b>	<b>24</b>
<b>F. Environment (including Safeguards) .....</b>	<b>25</b>
<b>G. Other Safeguard Policies (if applicable) .....</b>	<b>25</b>



<b>H. World Bank Grievance Redress .....</b>	<b>25</b>
<b>VII. RESULTS FRAMEWORK AND MONITORING .....</b>	<b>27</b>
<b>ANNEX 1: DETAILED PROJECT DESCRIPTION .....</b>	<b>43</b>
<b>ANNEX 2: IMPLEMENTATION ARRANGEMENTS.....</b>	<b>56</b>
<b>ANNEX 3: IMPLEMENTATION SUPPORT PLAN .....</b>	<b>71</b>





## I. STRATEGIC CONTEXT

### A. Country Context

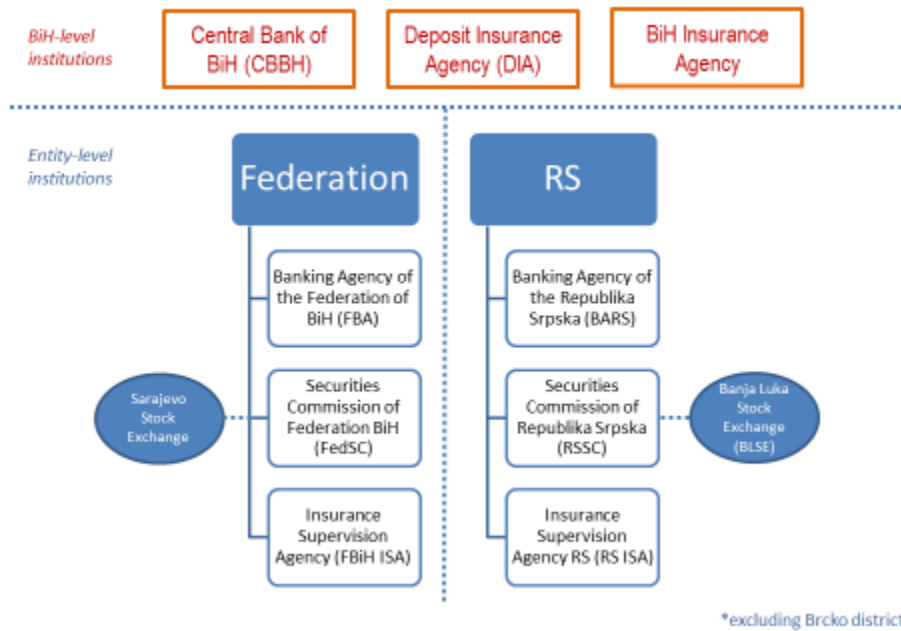
**1. After modest post-crisis recovery, Bosnia and Herzegovina (BiH) continues to struggle with structural problems that undermine economic growth.** Following the global financial crisis (2008/2009) and subsequent euro area crisis leading to a double-dip contraction of the economy, the country experienced 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.

**2. The growth potential of BiH would further benefit from a strengthened banking sector.** The banking sector is still dealing with the aftershocks of the global financial crisis that has weakened financial sector asset quality and profitability. High non-performing loans (NPLs) still burden bank balance sheets, undermine profits and capital, and constrain new lending as well as reduce the general ability of banks to support growth. Deleveraging remains a risk as some parent banks may plan to further scale back their presence in the region as a result of continued market and regulatory pressures. Shifts in banks' funding models, as well as low bank profitability levels, may require further banking sector consolidation to adjust to the new circumstances.

**3. BiH consists of two semi-autonomous political entities—the Federation of Bosnia and Herzegovina (FBiH) and the Republika Srpska (RS) (hereafter referred to as 'Entities'), and a Brcko District.** Both entities have their own parliament, government, judicial system and a stock exchange. Similarly, the regulatory and supervisory responsibilities for banking are separately undertaken in each Entity via two banking agencies and ministries of finance in accordance with their separate – yet mostly harmonized - laws and regulations. In addition, there is a BiH level administration with few enumerated powers. The Central Bank of Bosnia and Herzegovina (CBBH) and Deposit Insurance Authority (DIA) reside at the BiH level (see Figure 1 for further information). A currency board arrangement with the euro provides stability in an otherwise uncertain and complex environment.



Figure 1: Financial Sector Institutional Structure



## B. Sectoral and Institutional Context

### i. Banking Sector Structure and Performance

**4. 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<sup>1</sup> 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.

**5. Financial intermediation in BiH is relatively low when compared to new EU member states.** Banking assets and loans to GDP as of end 2015 stood at 85 percent and 59 percent respectively (see Figure 2) which is relatively low by regional standards (for example, Croatia and Slovenia both have assets and loans to GDP ratios above 100 and 60 percent respectively). Deposits to GDP are also lagging behind new member states at 58.3 percent of GDP (compared to above 80 percent of GDP in Croatia and Slovenia). Access to finance remains a constraint for enterprise development. Firms in BiH identified access to finance as the second biggest constraint after political instability in the 2013

<sup>1</sup> This figure does not entail the entity development banks.



Enterprise Survey. Only 52.7 percent of adults had accounts at a formal financial institution in 2014<sup>2</sup>, which lags significantly behind the 70.5 percent average ratio of other upper middle income countries.

Figure 2. Banking sector depth (% of GDP)

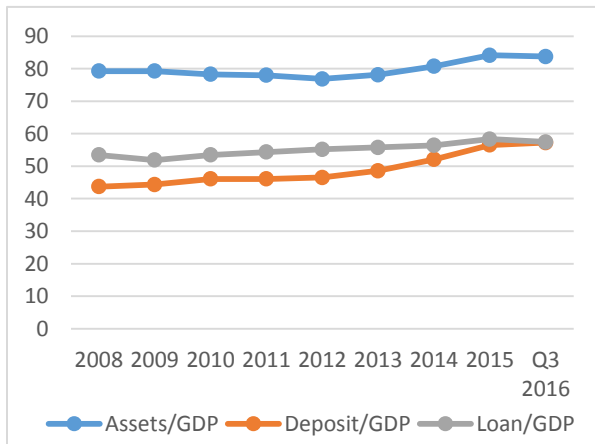
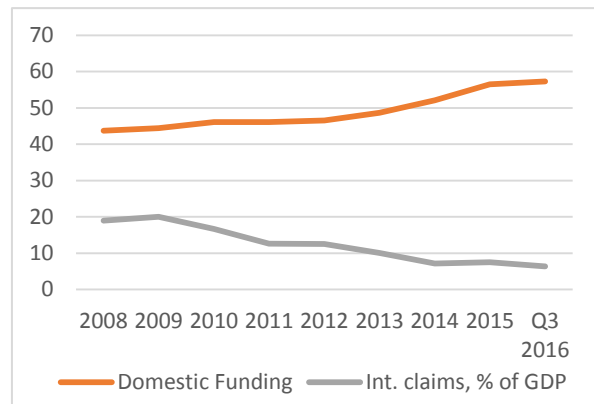


Figure 3. Banks' external and domestic funding (% of GDP)



Source: BIS, IFS, WEO, authorities in BiH

**6. As the BiH banking system is largely foreign owned, it has been exposed to deleveraging pressures, which have been partly compensated by greater mobilization of domestic funding.** Total customer deposits represent 66.4 percent of total liabilities (including equity), followed by capital and reserves (14.4 percent) and foreign liabilities (10.5 percent). Other types of borrowing represented only 8.7 percent of total funding sources. As a result of the slowdown in foreign funding, banks have become more reliant on domestic funding sources. From the pre-crisis peak (Q1, 2009) to end of 2015, the decline in cross-border funding has been an equivalent of almost 13 percent of BiH's GDP. Domestic deposit mobilization has increased by almost 11 percent in the same period, but this was not sufficient to compensate for the loss of foreign funding (see Figure 3).

**7. 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 NPL ratio – although on a slightly declining trend – remained high at 12.1 percent in Q3 2016, reflecting the impact 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.

**8. The banking system appears broadly sound but significant pockets of vulnerability exist among banks.** Bank governance problems, related party loans, questionable collateral valuation practices, and the inability of select shareholders to provide additional support are obstacles to

<sup>2</sup> Global Findex Database 2014.



strengthening capital ratios, addressing asset quality problems, and re-establishing bank profitability. In addition, there are legislative changes on retroactive conversion of credits indexed in Swiss francs (primarily with one bank) being proposed in FBiH. The cost of the proposed legislation would be borne by primarily one bank and would have a significant impact on its solvency. Finally, a number of banks are struggling to meet capital requirements and face deteriorating asset quality. Concentration risks faced by domestic banks are high with some relying heavily on public sector funding for liquidity and capital. In the RS, the Investment Development Bank (IRBR), utilizing the six development funds under its management, is holding a sizeable amount of subordinated debt issued by domestically-owned banks that would otherwise be undercapitalized.

**9. Two domestic bank failures over the past two years in the RS and concerns regarding the outcome of asset quality reviews (AQRs) of banks conducted in 2016 in RS and FBiH call for a strengthened institutional, regulatory and supervisory framework.** In December 2014, the RS Banking Agency (BARS) revoked the license of Bobar Bank. The bank was liquidated and the DIA initiated the first insured deposit payout in BiH. Banka Srpska's license was revoked in May 2016. DIA handled the payouts of these two small banks from its own resources and was able to replenish its funds from significant recoveries from liquidation proceeds.<sup>3</sup>

**10. In FBiH, the Federation Banking Agency (FBA) has approved two mergers<sup>4</sup>.** The merger of Privredna Banka Sarajevo (PBS) and BOR Banka (BB) – both domestically owned banks - resulted in an increase of about BAM 100 million in the amount of deposits insured by the Deposit Insurance Fund (DIF) because PBS was not yet a member of the deposit insurance scheme due to the bank having never fulfilled the DIA's membership criteria.

**11. 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.** Cooperation and coordination among the various institutions involved in banking oversight is very complex, having potential repercussions in times of financial sector stress. This was demonstrated to a degree by the events that led to investigations into the conduct of senior financial sector officials in RS and their indictment<sup>5</sup>. The authorities have made good progress in this regard, with the establishment of the Standing Committee on Financial Stability (SCFS) in December 2009 including CBBH, the two banking agencies, the DIA and the BiH and entity ministries of finance. The development of an integral contingency plan is encouraging in this respect but will require significant refinement once the formalization of resolution objectives, powers and responsibilities have been put into effect by the new banking laws. In addition, crucial information on the risk profile of banks (i.e. the CAMEL rating) is not always shared among relevant stakeholders creating information asymmetries. The current memorandum of understanding (MOU) between the banking agencies and the DIA is more than ten years old and information exchange would benefit from further improvement. This is currently being addressed with support of the International Monetary Fund (IMF) and the World Bank (WB).

<sup>3</sup> As of March 2017, recoveries for Banka Srpska amounted to around 69 percent and for Bobar Banka to around 95 percent.

<sup>4</sup> Moja banka d.d. Sarajevo merged with Investiciono-komercijalna banka d.d. Zenica and Privredna banka Sarajevo d.d., Sarajevo Merged with BOR banka d.d., Sarajevo.

<sup>5</sup> BiH prosecution said on February 2, 2017, it has issued indictments against 16 individuals, among them senior banking sector officials.



**12. 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. The main areas of deficiency are the inadequacy of resolution powers and tools as well as resolution financing arrangements. Supported by the IMF and the WB, both entities prepared amendments to their respective banking laws in order to establish clear responsibility for bank resolution and resolution tools vested with the banking authorities. Implementation of the banking laws will be challenging due the limitations in resources and capacity at the level of the banking agencies as new resolution authorities.

**13. Banking regulation and supervision must also be further strengthened.** 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. Areas in need of further attention are: country risk, interest rate risk in the banking book, and guidance on holistic governance and risk management requirements for banks. The capital adequacy and liquidity regime currently in place – a hybrid of Basel I incorporating the definitions of core capital elements from Basel III – as well as the underlying supervisory review and reporting framework require further strengthening and harmonization across BiH. In addition, the implementation of a revised supervisory risk-based methodology aligned with the EU Supervisory Review and Evaluation Processes (SREP) would be advisable, aimed at enhancing transparency and harmonization of supervisory review processes.

**14. Finally, the development banks require operational and institutional reform to avoid distortive impacts on the banking sector and facilitate sound corporate governance.** The institutional arrangements for the development banks in BiH require reform to strengthen both banks' governance and risk management practices in line with international practice, and to update the banks' strategies to reflect current market failures and development financing needs. While Federation BiH Development Bank (RFBiH) and IRBRS differ in terms of operations conducted and their size, they both face significant weaknesses with regard to their institutional and governance arrangements. Both banks should focus their operations on sectors where market failures are pervasive and which are thus underserved by commercial banks or other private finance providers. The development bank's operations should serve to 'crowd in' private sector finance by demonstrating the viability of solutions to market failures rather than focusing on profitable projects where the bank is 'crowding out' private sector financial services. Such market failures relate to areas typical for development bank finance in the region, i.e. such as a lack of finance for infrastructure, small and medium-size enterprises, or export finance.

**15. In general, the RFBiH's overly wide mandate creates a range of governance concerns, and risks diffusing – and thus making less effective - the impact of the bank.** The RFBiH is small, with its loans amounting to only 2.4 percent of FBiH GDP by end-2015. The bank has two main business lines: (a) direct lending to commercial or public sector borrowers, and (b) a portfolio of loans funded by Entity ministries and the State Employment Fund, where the bank acts as a managing agent in exchange for a fee, but is not itself at risk. Loans made directly by the bank need to meet creditworthiness and risk criteria, whereas loans made by the ministries may not be made in accordance with the same standards given that the ministries can and do over-ride the bank's credit assessment of borrowers. The mandate of the RFBiH should be further clarified and narrowed by



clearly stipulating in a new FBiH Government-approved strategic statement the market failures the development bank is supposed to address and focus on crowding in private sector finance. The strategic statement should define the bank's main business policies and provide a basis for the bank's management to develop a business plan that describes and quantifies how the bank will implement each policy.

**16. RFBiH has limited organizational capacity and is only partially and indirectly supervised by the banking regulator.** It is only partially supervised by the FBA, in line with the Decree on the Bank Supervision Criteria and Procedures of the RFBiH. The decree does not allow the FBA to sanction the bank for violating regulations or to veto appointments to its supervisory or management boards. Power for setting supervisory and regulatory requirements for RFBiH should be exclusively with the FBA. RFBiH should not be treated differently from other banks, and only very limited exemptions from regulatory requirements should be allowed in view of its funding model. Moreover, the current risk management structure is not in line with international practices, which call for its independence from management and for direct reporting to the supervisory board.

**17. The IRBRS combines the roles of development institution with that of a fund manager. It lacks both focus and strategy, and represents governance concerns.** The IRBRS performs several functions. These include development finance functions, management of RS government-owned funds, and the role of a lender of last resort for domestic banks. Together these portfolios – consisting exclusively of assets owned by the trust funds - account for about 25 percent of the RS's GDP. As a result, while it is called a "bank", the IRBRS operates entirely as a fund manager and does not provide credit on its own account. Thus, it does not operate as a classic development bank and is not supervised by BARS. The bank controls the operations of six legally separate Funds, with total assets of about KM 2.2 billion, representing a significant amount of Entity-owned assets. The structure and multiple mandates of IRBRS are undesirable from both a fiscal and financial stability point of view. IRBRS and the six funds it manages should be transformed to become a development bank with well-defined developmental objectives responding to well-identified market failures, a clear list of eligible activities, a viable strategy and business model, and robust governance, external supervision and risk management.

**18. The Funds have in some cases been used as "lenders and investors of last resort" to local banks.** The IRBRS has played a major role in providing policy-based credit lines for on-lending by RS banks; but it has also provided sizeable deposits, debt, and capital to RS banks under its mandate taken from the current IRBRS Law to provide "anti-crisis" support for the financial sector. Two of the domestic banks involved (Bobar Banka and Banka Srpske) have failed. Lending and investment of this type undermines discipline in the financial sector by providing lender of last resort funding without the conditions normally attached to it.

*ii. Government Measures to Strengthen the Banking Sector*

**19. The medium-term Reform Agenda (2015-2018) focuses on – among other issues – safeguarding financial sector stability and the creation of conditions necessary to revive the growth of bank lending to the private sector.** The reform agenda represents a broad consensus amongst stakeholders on the key priorities for economic and social development, and is aimed at placing BiH on a more sustainable growth trajectory. As part of financial sector reform priorities, it foresees adoption



of financial sector legislation to modernize the frameworks for bank regulation, supervision, and resolution.

**20. In parallel, both banking agencies have adopted strategic plans to strengthen banking sector regulation and supervision.** Both agencies have adopted strategies for convergence with international capital measurement and capital requirements ('Basel implementation strategies') and EU Directives, as applicable to the level of development of the domestic financial market, while at the same time strengthening the capacity of the Entity banking agencies to supervise their banking systems. In addition, FBA and BARS adopted action plans in December 2015 focused on implementation of reform areas identified in the IMF/WB 2014 Financial Sector Assessment Program (FSAP). Implementation of the action plans has well advanced with the completion of a number of draft bylaws including the Draft Decision on Capital Calculation (Pillar 1), Draft Decision on Internal Capital Adequacy Assessment Process in Banks (ICAAP – Pillar 2), Draft Decision on Risk Management in Banks (Pillar 2), Draft Decision on High Exposures (Pillar 2), Draft Decision on Interest Rate Risk Management in Trading Book (Pillar 2), Draft Decision on Liquidity Risk Management in Banks. All draft decisions have undergone public consultation, with exception of the Draft Decision on Liquidity Risk Management, which was prepared and sent to the banks in draft form as part of the Quantitative Impact Study (QIS).

**21. AQRs have been instrumental in revealing risks in individual banks and have been followed by supervisory measures, i.e. banks booked additional provisions and had to make measures to address other weaknesses, in particular in the area of risk management.** It is important to recognize that the AQR exercise has been undertaken in three phases: the first AQR (2013/2014) assessed six banks under special supervision; the second AQR (2016) covered weak banks and those banks which had expanded at an accelerated pace, and third AQR (2017) will assess the remaining banks. The first AQR contributed significantly to revealing substantial supervisory forbearance and paved the way for the measures eventually taken by the authorities to liquidate two of small domestic banks. In 2016, nine additional AQRs (five in FBiH and four in RS) were carried out by the "Big Four" audit firms to assess the condition of banks that evidenced credit growth in excess of 10 percent from 2012 to 2014, or had been under enhanced supervision in 2015, and that had not already conducted AQRs. The second AQR resulted in significant additional provisioning requirements for some of the small banks in particular, which will require corrective supervisory actions. The second AQR also revealed important shortcomings in risk management practices of banks (i.e. weak underwriting practices, collateral overvaluation, evergreening etc.) and a rather lenient supervisory approach in credit risk supervision. Under the circumstances, the proposed enhancements to the AQR methodology were necessary to produce better quality and more consistent results. In late 2016 both banking agencies adopted a uniform AQR framework for the 2017 AQRs in accordance with the text agreed between the agencies, the WB and IMF. These AQRs will cover all remaining banks that have not yet been subject to an AQR (12 in total – 4 in RS and 8 in FBiH) and will also provide indications whether changes in relevant regulations and/or supervisory practices are required. The AQR process was initiated by the banking agencies and is expected to be completed by end Q3 2017.

**22. The authorities have made progress towards strengthening the financial safety net.** The authorities have established contingency plans covering their respective responsibilities and a coordinated cross-agency plan was prepared in November 2014. Supported by the IMF and the WB, RS and FBiH both adopted new Banking Laws<sup>6</sup> that will vest FBA and BARS with clear responsibility for

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<sup>6</sup> Consisting, respectively, of Law on Banks and Law on Banking Agency. The FBiH Law on Banks and Law on Banking Agency has



bank resolution and provide a wide range of resolution tools - including bail-in - in line with the EU Bank Recovery and Resolution Directive (BRRD).

**23. The entity governments made progress in preparing new legal frameworks governing the Entity development banks.** The recent technical assistance missions from the IMF and the WB have revealed deficiencies in the banks' mandates and objectives, governance, operational transparency, and risk management practices. This warrants a comprehensive overhaul of the development banks' governing laws. The Entity governments are preparing drafts (expected to be enacted in mid-2017) of new legislation governing the development banks to address the identified deficiencies in consultation with the IMF staff and the WB.

**24. In May 2016 BiH and the entities reached an agreement with the IMF for an Extended Fund Facility (EFF) that commits the authorities to undertake a broad range of reforms.** Among others, the authorities committed – with assistance from the IMF and the WB - to strengthen banking sector legislation (in particular the Banking Laws, Banking Agency Laws and Deposit Insurance Law), enhance coordination and address weaknesses in the banking sector and reform the entity development banks. In this context, the WB operation – complementary to the EFF - is aimed at supporting the authorities in actual implementation of the envisaged policy and legislative reforms, in particular related to strengthening the bank resolution and supervisory framework and introduction of the bank resolution regime.

### C. Higher Level Objectives to which the Project Contributes

**25. The proposed project is consistent with the 2016-2020 Country Partnership Framework (CPF) which calls for safeguarding macroeconomic and financial stability as well as fostering access to finance.** The CPF states that maintaining the stability of the financial sector is a fundamental condition for maintaining macro-fiscal stability in the country. The CPF is based on the findings of the 2014 FSAP highlighting a number of banking sector vulnerabilities including high levels of NPLs, weaknesses in the domestic banks, gaps in the financial safety net, and a need to strengthen the framework for bank resolution. The banking sector in BiH plays a key role in providing resources to the most productive sectors of the economy and therefore contributes to growth and employment in line with the WB twin goals.

## II. PROJECT DEVELOPMENT OBJECTIVES

### A. PDO

**26.** The Project Development Objective (PDO) is to improve the soundness of the banking sector by enhancing bank regulation, supervision, and resolution capacity and by enhancing the governance of the Entity Development Banks. Soundness of the banking sector is defined as compliance with prudential norms and capital adequacy and liquidity as well as the existence of a modern regulatory and supervisory

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not been published yet.



framework.

## **B. Project Beneficiaries**

**27.** The specific project beneficiaries will be households and enterprises in BiH benefiting from a more stable and efficient banking sector as a whole as well as several key banking sector regulatory and supervisory institutions and the Entity development banks.

## **C. PDO-Level Results Indicators**

**28.** The PDO indicators include the following:

PDI 1

a) All banks remain well-capitalized (defined as each bank in BiH meeting regulatory capital adequacy requirements)

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

PDI 2:

- Banking agencies performing their legally mandated technical functions in bank resolution.

PDI 3:

- New governance and business model for entity development banks adopted.

**29.** These PDO level indicators are underpinned by a series of disbursement linked indicators (DLIs) that will be utilized to achieve these results (see section VII for further detail). Annex 1 presents the DLIs and the targets for disbursements.

## **III. PROJECT DESCRIPTION**

### **A. Project Components**

**30.** The PDO 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

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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.

**31. 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.

**32. The project will follow the results-based format focused on financing the achievement of outcomes.** This format has been chosen over a Program-for-Results (PforR) as there are no clearly identified budget commitments towards any financial sector program to link the PforR to and it is therefore difficult if not impossible to find clear boundaries for the PforR operation. WB financing will be made available to the entity MoFs in several tranches based on the achievement of a set of disbursement linked indicators. Complementary technical assistance to support the entity governments and agencies to achieve the goals set forth in the program will be provided by the WB with trust fund assistance. 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 portion of the loan is therefore set aside for technical assistance and operational costs.

**33. The project is built around five components; four 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.** The fifth component is earmarked for technical assistance and operational costs. The project 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 (see Annex 1 for a list of DLIs).

***Component 1: Strengthening regulation and supervision aligned with the Basel III regime, tailored to the level of development of the banking sector***

**34. Component 1 focuses on strengthening banking sector regulation and supervision aligned with the Basel III regime, tailored to the level of development of the banking sector.** 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 SREP aimed at enhancing transparency and harmonization of supervisory review processes.

***Component 2: Addressing weaknesses in the banking sector***

**35. 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 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***

**36. 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 BARS and FBA, adoption of an internal assessment methodology for recovery plans and subsequent assessment of recovery plans to be submitted by all banks to FBA and BARS.

***Component 4: Improving governance and business model of entity development banks***

**37. Component 4 supports strengthening of institutional, corporate governance, and supervisory arrangements of the entity development banks, and updating their strategies.** 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' risk management organization, reporting lines, and policies and procedures with those required for FBA/BARS-regulated banks.

***Component 5: Technical assistance***

**38. The selection of reform areas also takes into account gaps in assistance and areas already being supported by other development partners.** Complementary technical assistance to support the entity governments and agencies to achieve the goals set forth in the program will be provided by the WB with trust fund assistance. Specifically, the project is currently complemented by resources from the WB Vienna Financial Sector Advisory Center (FinSAC) and the UK Good Governance Trust Fund (see Box 1 for further information on FinSAC). A list of development partners and International Financial Institutions (IFI) engaged in financial sector reforms is available in Table 3.

**Box 1: FinSAC Engagement in BiH**

The Financial Sector Advisory Centre (FinSAC) was established in Vienna in 2011 as a dedicated technical unit delivering financial sector reform advice and implementation assistance to client countries in the ECA region. It is part of the WB Finance and Markets Global Practice and is financed by Austria's Federal Ministry of Finance. FinSAC is a regional "knowledge center" focused primarily on three broadly defined thematic areas: first, macro-prudential supervisory frameworks and crisis management; second, micro-prudential supervision and regulation including the resolution of NPLs; and finally bank recovery and resolution.

*FinSAC in BiH*

Following the 2014 FSAP, FinSAC – at the request of the BiH authorities – initiated extensive technical assistance activities in the areas of deposit insurance, bank regulation and supervision and the financial safety net.



*What has been achieved so far and next steps:*

Jointly with the IMF, WB FinSAC experts provided advice to the authorities in drafting a bank resolution framework – an integral part of the newly adopted Banking Laws. Following passage of the Laws, FinSAC has initiated activities to assist the banking agencies in the operationalization of the new framework with a focus on i) assistance in the establishment of the new resolution unit; ii) assistance in the adoption of key by-laws; iii) assistance in the assessment of individual recovery plans; v) assistance in the adoption of a resolution manual and resolution plans including the identification of possible additional reporting needs.

FinSAC worked with the banking agencies to conduct a Quantitative Impact Study (QIS) of its draft capital and liquidity regulations. Assistance going forward will focus on supporting the banking agencies in their efforts to strengthen banking sector regulation and supervision in line with the Basel regime in particular the drafting of a regulation on consolidated supervision as well as implementation of a supervisory risk-based methodology aligned with the EU SREP.

FinSAC technical assistance focused on support to the DIA in amending the Law on Deposit Insurance including on usage of the deposit insurance fund in bank resolution. The revised law – which is expected to be adopted in Spring 2017 - incorporates the recommendations of the 2014 FSAP. In addition, FinSAC technical assistance to the DIA in developing a target fund ratio methodology is ongoing. The target fund ratio which is complementary to the DIA's Analysis of Adequacy will provide the DIA with a long term funding goal.

**39. 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, particularly in the support needed for the development banks in both entities. These funds may be substituted by other donors during project implementation, however, these would be outside the control of the project both in terms of content and the timeline. To minimize these risks, a portion of the loan is set aside (up to EUR 1.9 million for both entities) to be used towards expenditures and needs for technical assistance. If unused, these funds will be allocated to any activity that forms part of the project.

**40. These areas have been selected based on the strategic relevance of the reform areas and specific requests form the authorities for assistance from the WB.** Annex 1 presents the detailed project description.

## B. Project Cost and Financing

**41. Details of the project cost and financing are provided in the table below.** The total amount of the loan will be EUR 56.6 million<sup>7</sup>. The loan will be shared between the two entities, the RS and the FBiH, in equal proportions. In addition, complementary grant financing amounting to USD 730K has been secured via FinSAC and the UK Good Governance Trust Fund aimed at supporting the authorities in implementing the banking sector strengthening operation. The WB is in the process of seeking further funds to support the technical assistance, in particular that to the development banks. Of the total

<sup>7</sup> Using exchange rate as of February 28 2017, the last day of the month preceding negotiations.



amount, EUR 1.9 million (EUR 950K for each entity) is allocated to be used for the technical assistance and operating costs. This amount can be re-allocated to any project activity during the implementation period.

**Table 2. Project Cost and Financing**

Project Components	Project Cost			IBRD Financing		Trust Funds <sup>8</sup>	Percent IBRD Financing per Entity	
	Total (EUR mln)	RS (EUR mln)	FBH (EUR mln)	RS (EUR mln)	FBH (EUR mln)	Allocation across entities (USD mln) <sup>9</sup>	RS (%)	FBH (%)
Improving bank regulation and supervision, addressing weaknesses in the banking sector, establishing a bank resolution framework and enhancing governance and operation of the entity development banks	54.7	27.35	27.35	27.35	27.35	0.73	100	100
Technical assistance	1.9	0.95	0.95	0.95	0.95			
<b>Total Costs</b>	<b>56.6</b>	<b>28.3</b>	<b>28.3</b>	<b>28.3</b>	<b>28.3</b>	<b>0.73</b>	n.a.	n.a.

**C. Lessons Learned and Reflected in the Project Design**

**42. Past WB financial sector projects in the wider region have shown that having both a solid legal framework and well-resourced implementation bodies is critical for a stable and efficient banking system.** In this regard, the proposed project is based on a solid legal framework for banking aligned with EU requirements. As part of project preparation discussions, the team – in cooperation with the IMF - shared with the authorities a number of comments on the draft banking and deposit insurance legislation. These have been largely taken into account in the final legislation package adopted at end 2016 in RS and in early 2017 in FBiH. Since a solid legal framework has now been put in place, the focus of this operation is– complementary to the EFF - to support the authorities in actual implementation of the undertaken policy and legislative reforms, in particular related to strengthening the bank resolution and supervisory framework and introduction of the bank resolution regime. A Results-Based Investment Project Financing is considered to be the optimal instrument to achieve this goal, as by design it focuses

<sup>8</sup> The TF financing is not part of the overall IBRD financing allocated to this project.

<sup>9</sup> The TF allocation will be used equitable across entities.



more on achieving and sustaining actual results rather than legal or policy changes.

**43. Transparent reporting, sound governance arrangements, and independent and effective regulation and supervision, as well as wholesale business models, are key factors in developing sustainable development finance institutions (DFIs).** Accurate and detailed financial and performance reporting is essential in maintaining a self-sustaining institution. Independent regulation and supervision by the financial sector regulator rather than a line ministry with conflicts of interest further enforces the disciplined prudent management of a DFI. Experience in South Africa and Brazil suggests the importance of tightly defined mandates, clear performance targets, transparent reporting, and insulation from political interference. DFIs that apply strong corporate governance standards generally perform better. International experience relating to DFI reform, e.g. in Mexico, confirms that wholesale DFIs (second tier institutions) that provide incentives to private sector banks to enter new markets perform better than DFIs that engage in retail operations.

**44. A number of lessons have been incorporated in the project's design, in particular from projects in other countries with similar activities and objectives, including the needs to:**

- **Maintain a flexible design able to respond to the borrower's needs and priorities that can emerge in the implementation process.** In particular, the project takes into account potential developments in BiH's financial market and includes space to integrate these into the new regulatory and supervisory regime as and when needed.
- **Provide a comprehensive approach to banking sector reform.** The project attempts to provide a holistic approach to institutional, regulatory and supervisory strengthening for the banking sector including resolution.
- **Building in resources for capacity building and aim for capacity building efforts to be sustainable.** The project is supported by donor financing aimed precisely to assist the relevant authorities in building long term capacity to respond to implementation demands beyond the selected results areas of this operation and ensure their long term sustainability.

**45. A key lesson from past technical assistance and lending operations in the financial sector in BiH is that reforms work best when coupled with extensive technical assistance.** The Small and Medium-sized Enterprise (SME) Access to Finance project and its Additional Financing disbursed a total of US\$157.7 million, supporting 338 firms. Apart from enhancing SME financing, the WB supported in FY11-13 financial sector strengthening under FIRST (Financial Sector Reform and Strengthening Initiative). Key activities included the diagnostic review of banking and microfinance institutions, an action plan for consumer protection in banking and microfinance sectors focused on EU alignment, and strengthening the related legal and regulatory framework. The International Finance Corporation (IFC) implemented a unique countercyclical financing package and advisory services to support the banking sector's financial capacity during global economic slowdown. IFC supported client banks to bolster their operations within underserved segments, including local banks, by providing long term finance for on-lending to housing finance and SMEs. IFC advisory services supported the stabilization of the microfinance sector by working directly with lead microfinance institutions to improve their standards of client service delivery by having them go through a rigorous SMART campaign certification process to reinforce the concept of responsible finance, which is now gaining credibility and is embraced by the regulator. IFC also assisted in setting up debt advice networks throughout the country to mitigate effects of over-indebtedness, in particular with users of microfinance services.



## IV. IMPLEMENTATION

### A. Institutional and Implementation Arrangements

**46. There will be a small PIT at each entity MoF.** In addition, focal points will be appointed at each of the banking agencies and the entity development banks to support and complement the operation of PITs.

**47. The implementation arrangements 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 technical assistance procurement should this be required, 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, satisfactory to the WB. Having a PIT for at least one Entity in place with names of the individuals responsible for monitoring and financial management communicated to and agreed by the WB will be an effectiveness condition.

### B. Results Monitoring and Evaluation

**48. The results monitoring and evaluation will be a responsibility of RS and FBiH Ministries of Finance.** The main outcome indicators for the project and intermediate results indicators (listed in section VII) and DLIs (listed in Annex 1), will serve as the basis for results monitoring and evaluation. PITs will be responsible for collecting the data required for monitoring and evaluation and for verification of the DLIs under their responsibility based on the protocol outlined in Annex 2. MoFs will measure indicators against agreed targets and compare them to defined baselines. These will be collated and form part of the project progress reports to be prepared by the entity MoFs on a semi-annual basis and submitted to the WB.

### C. Sustainability

**49. It is expected that the project results will have a long-term impact on the soundness of the banking sector, given the breadth and depth of reforms proposed.** The project is designed to support existing relevant authorities to implement and achieve results committed to within strategic and action plans, and the reform agenda. The results selected for this operation are embedded in the work program of banking agencies and entity governments alike and form an integral part of the overall initiative, supported by the IMF and the WB, to strengthen and further develop the financial sector and approximate to the EU. First, key project interventions have been explicitly designed to support the capacity building needs of banking sector regulators and policymakers. Second, the project promotes



safety, soundness, and sustainability by improving the existing bank regulatory and supervisory framework and resolution. Third, the project will help reduce distortions in the banking sector through improvements in the institutional, governance, and supervision arrangements for the entity development banks. This institutional improvement and strengthening approach endorses sustainability of the reforms and the banking sector in the longer term by creating a sound and stable environment to foster bank lending. This approach is built on and depends on the results-based design of the project.

#### **D. Role of Partners**

**50. The implementation of financial sector reforms is supported by the WB, the IMF, the European Bank for Reconstruction and Development (EBRD), United States Agency for International Development (USAID), KFW and the EU.** In May 2016 BiH and the entities reached an agreement with the IMF for an EFF that commits the authorities to undertake a broad range of reforms. Among others, the authorities committed – with assistance from the IMF and the WB - to strengthen the banking sector legislation (in particular the Banking Laws, Banking Agency Laws and Deposit Insurance Law), enhance coordination and address weaknesses in the banking sector and reform the entity development banks. In this context, the WB operation – complementary to the EFF - is aimed at supporting the authorities actually implement the envisaged policy and legislative reforms, in particular related to strengthening the bank resolution and supervisory framework and introduction of the bank resolution regime. A summary of some of the main development partners’ activities are listed in Table 3.



**Table 3: Development Partner Financial Sector Activities in BiH**

Institution/Agency	Primary Focus
IMF	Three main objectives: <i>Structural Reforms</i> : Raise growth potential and boost private sector employment by intensifying structural reforms that improve the business environment and attract investment. <i>Fiscal Policy</i> : Improve the composition and quality of public spending, while gradually lowering public indebtedness and <i>Financial Sector</i> : Revive bank lending and credit growth while safeguarding financial stability through financial sector reforms. The arrangement will also help improve coordination and cooperation among the authorities in BiH to strengthen the single economic space.
EBRD	Focus on supporting restructuring and expansion of the local private sector, forging closer linkages with wider regional markets and promoting a more efficient and sustainable use of resources whilst continuing to coordinate the EBRD’s activities with the EU and IFI partners. Backup financing for the DIA.
KfW	Credit Guarantees, advisory to DIA, energy efficiency and renewable energy
USAID	Improve economic opportunities and promote a business-friendly environment by supporting efforts to increase competitiveness and productivity, attract investment, and make economic policy reforms. Targeted sectors with the highest growth potential: agriculture, wood products, tourism, and light manufacturing. USAID uses Development Credit Authority credit guarantees to improve access to finance for SMEs and capitalizes on technical assistance through other programs, including transparent banking, investment, and insurance policies.
World Bank Group	Overall legal and regulatory framework in banking and microfinance, insolvency legislation, development bank restructuring, debt counselling, payment systems.

## V. KEY RISKS

### A. Overall Risk Rating and Explanation of Key Risks

**51. The overall risk to the operation is substantial.** In particular, complex governance structures and heightened political tensions pose a risk to this operation.

**Table 4. Systematic Operations Risk-Rating Tool (SORT) Summary Table**

Risk Category	Rating
1. Political and Governance	Substantial
2. Macroeconomic	Moderate
3. Sector Strategies and Policies	Moderate



Risk Category	Rating
4. Technical Design of Project or Program	Substantial
5. Institutional Capacity for Implementation and Sustainability	Substantial
6. Fiduciary	Moderate
7. Environment and Social	Low
8. Stakeholders	Moderate
OVERALL	Substantial

**52. Political and Governance.** The main policy risk relates to the ability and willingness of authorities to pursue comprehensive structural financial sector reforms. The stability of BiH’s financial system depends on continuous progress in and a commitment to a number of sensitive reform areas, including banking supervision and regulation, the bank resolution framework, addressing weaknesses in specific banks, and transforming the development banks and increasing the transparency of their operation. As a mitigating factor, there is a universal agreement with key development partners (EU, IMF, EBRD, KfW, USAID) on the importance of above-mentioned agenda, which has been central to recent policy discussions with the authorities. The adoption of the three-year IMF EFF program provides an anchor for the medium-term macro-fiscal framework and, in conjunction with related WB operations including the Public Finance Development Policy Loan (DPL) and this operation, help to mitigate these risks. Nevertheless, in a complex political environment like the one in BiH, there are often political challenges in advancing such a reform agenda. To mitigate this risk, the WB will continue to collaborate very closely with the IMF, EC and other donors in helping the authorities advance the Reform Agenda, including through exchanging information and policy advice on areas directly related to the IMF program. It is expected that the WB, along with other development partners, will remain actively engaged through policy dialogue and technical assistance in particular via FinSAC and the UK Good Governance Trust Fund in implementing the ambitious banking sector reform agenda outlined in section III above. Substantial political risk surrounds reforms of development banks when it comes to commitment and ownership to tackle key reforms surrounding its comprehensive restructuring. This is why targeted technical advisory and support will be made available to assist MoFs and development banks communicate reasons and goals of the transformation and how the development banks will identify and help close market failures and crowd in private sector finance within their new mandates. The fragmentation of the institutional framework and lack of coordination between key stakeholders generates the main operational risk. The project aims to address banking sector weaknesses in a holistic manner, introducing the same results for both entities. The overall Reform (EU) Agenda has slowed down, despite attempts by the authorities to fulfill their obligations and unlock the key socio-economic impediments for BiH’s growth. At the authorities’ level (and the banking agencies) commitment remains high, despite the overall complex political situation. Financial sector reforms are considered vital, are uniform and harmonized to the greatest extent, a major accomplishment in BiH circumstances, and are driven by the demands of the IMF/EU/WB – for adjustment to the requirements of the European financial sector.

**53. Technical design.** The project will be housed in the Ministries of Finance in both entities; however, the banking agencies and entity development banks will be responsible for implementation of key disbursement linked results. This level of complexity presents challenges for project



implementation, within both BiH and the WB. In addition, some of the reforms that must be undertaken to achieve the DLIs will require substantial technical assistance from external consultants. It might be challenging to provide sufficient technical and operational advice with complementary trust funded technical assistance and WB supervision resources for each of the components. There is a risk that the technical assistance resources supported by trust funds may not be adequate from a technical, financial, or timing perspective since they would be outside of the control of the project. To safeguard against this risk, a portion of the loan has been set aside for technical assistance that can be used toward expenditures and needs, in particular for the technical assistance part and those expenditures to achieve DLIs.

**54. Institutional capacity for implementation and sustainability.** The project could potentially be delayed or negatively affected by the weak implementation capacity and lack of experience of the key implementing institutions. A clear division of responsibilities and up-front agreement on the deliverables is expected to mitigate the coordination and harmonization risk across entities. The project could also potentially be delayed or negatively affected by the limited capacity of the key implementing institutions, especially the banking agencies, which have not previously implemented IBRD operations. The establishment of dedicated implementation units at entity MoFs is expected to mitigate this risk.

## VI. APPRAISAL SUMMARY

### A. Economic and Financial (if applicable) Analysis

**55. The successful implementation of this project would lead to significant economic benefits for BiH.** Strengthening bank regulation and supervision, and implementation of a modernized bank resolution framework will increase confidence in the banking system, which is important in view of the fragility of BiH's economic recovery, and the deteriorating asset quality and low profitability of banks. Increased confidence would stimulate the channeling of domestic savings through the banking system that can then be intermediated for productive investment, leading in turn to increased growth and employment.

**56. The strengthening of bank supervision is critical for enhancing financial stability and thus the financial safety net in BiH.** Current stress tests of the banking sector indicate that a number of banks will fail in the event of a significant economic downturn and the deposit insurance fund is not adequately capitalized to handle all of these failures. If such a severe economic downturn were to occur, it is likely that fiscal resources would have to be diverted to protect depositors and reduce second round effects of such an event.

**57. The new laws on banking and banking agencies will provide a more detailed formulation of requirements that banks will have to meet.** These changes will harmonize the approach to bank supervision in BiH to that of the EU which will make it easier for EU banks to operate in the country. The law will also allow for the introduction of capital buffers for banks deemed systemically important, mostly foreign banks, and will assist in minimizing the chances of a systemic crisis. In addition, enhancing liquidity risk controls and supervisory policies are critical for financial stability, given that the central bank is unable to act as a lender of last resort due to its currency board regime for monetary policy.



**58. While the two recent bank failures have been relatively costless to the deposit insurance fund, they have inflicted costs on uninsured depositors and other creditors.** Since the DIA in BiH, has insured depositor preference, the bulk of the losses from failures will fall on uninsured depositors. In the case of the two banks about 63 percent of total deposits, or deposits equal to KM 245 million will experience losses. As a result, it is likely that depositors will split deposits to gain coverage of their total deposits; leading to an increase in insured deposits and greater exposure for the deposit insurance fund. Hence, the first line of defense for this fiscal exposure is enhanced supervision as envisioned in the legal and regulatory changes included in this program.

**59. One of the goals of the conditionality associated with this loan is to eliminate the role of the RS development bank in the banking sector as a lender of last resort.** To date it has invested KM 730 million in banks in the form of shares, senior and subordinated debt, and deposits. As a result of the recent failure of one of these banks, there is likely to be a fiscal loss of KM 76 million. Other banks that have been invested in could potentially encounter financial difficulties with further fiscal costs. Disengagement of the development bank from this activity should help to protect from future losses.

**60. There is clear evidence from other countries that having alternative resolution tools both mitigates the adverse economic effects of bank failures and can reduce the explicit and implicit costs of dealing with bank insolvencies.** The ability to resolve a bank quickly and assure that insured depositors have quick access to their funds is critical for maintaining confidence in the deposit insurer and the banking sector, and potentially has macroeconomic implications.<sup>10</sup> These macroeconomic impacts are likely to be magnified in developing economies where any loss of confidence in the banking sector can have significant implications for financial intermediation.

## B. Technical

**61. The design of the project is based on the findings and recommendations of the 2014 FSAP, the project team's gap analysis on bank regulation and supervision report, assessment of the development banks, as well as the revised AQR methodology.** DLIs are shaped by the findings and recommendations of the 2014 FSAP and will be in line with the authorities' respective reform agendas and the commitments made under the IMF EFF. The team is coordinating closely with the EBRD, IMF, EU, USAID and KfW.

**62. The design of Component 1 was informed by 2014 IMF/WB FSAP, in particular the Technical Note on Banking Sector Supervision Core Principles Implementation Update<sup>11</sup>, as well as a gap analysis on bank regulation and supervision conducted by the WB in Fall 2016.** The assessments found that – while shortcomings remain – both supervisory authorities have made progress in enhancing the regulatory framework and supervisory processes since the 2006 FSAP. With adoption of the new Laws on Banks deficiencies in the supervisory powers, resolution tools, and consolidated supervision will be addressed. However, while the new Banking Laws represent a major achievement, they will take several years to be fully implemented. Thus the project will support implementation of associated implementing

<sup>10</sup> See Kaufman, George and Steven Seelig. "Post-Resolution Treatment of Depositors at Failed Banks: Implications for the Severity of Banking Crises, Systemic Risk, and Too Big To Fail." *Economic Perspectives* vol.26. 2002. Federal Reserve Bank of Chicago.

<sup>11</sup> <http://documents.worldbank.org/curated/en/967801467997258285/pdf/98303-WP-P150589-PUBLIC-Box393168B.pdf>.



regulations for the laws. The team conducted a gap analysis of supervisory methodologies and procedures (i.e. supervisory information, risk-based supervision, etc.) that provides further insights and arguments for the prioritization of bank supervision reforms to be supported by the project. In particular, the analysis emphasized the importance of adoption of a new risk based supervisory review methodology to strengthen existing supervisory processes.

**63. As a result, one of the pillars of the supervisory regime reform supported by the project is the migration from a CAMELS-based to a SREP-based supervisory system.** Both, FBA and BARS, have traditionally used CAMELS as a bank supervisory rating system. CAMELS assesses the capital position, liquidity, earnings, management and asset quality of each bank; banks with lower CAMELS ratings should expect supervisory actions (dividend restrictions, enhanced supervision, etc.). However, the CAMELS rating does not recommend capital or liquidity requirements for banks based on their riskiness. SREP Methodology on the other hand is based on four elements aimed at improving the link between an institution's risk profile, its risk management and risk mitigation systems, and its capital planning. It gives supervisors a harmonized set of tools to examine a bank's risk profile from four different angles:

- *Business model:* supervisors assess the sustainability of each bank's set-up, in other words, whether it has a wide array of activities or whether it focuses on only a few lines of business.
- *Governance and risk management:* supervisors look into a bank's organizational structure by monitoring its management bodies and checking whether risks are being managed properly.
- *Risk to capital:* supervisors analyze whether a bank has a sufficient safety net to absorb losses arising, for example, from cyber-attacks on the bank's IT system, a sharp fall in oil prices, or borrowers not paying back their loans on time.
- *Risk to liquidity and funding:* supervisors check a bank's ability to cover ad hoc cash needs, for example, in times of economic uncertainty when depositors may withdraw much more money than usual.

Tailored to the individual bank, in the SREP decision, the supervisor may ask the bank to hold additional capital and/or set qualitative requirements (usually referred to as "Pillar 2"). The latter could refer to the bank's governance structure or its management. Moreover, introduction of the SREP methodology will further enhance on-site supervisory activities as the SREP assessment demands proper planning and performance and helps identify areas that shall be subject to on-site inspections.<sup>12</sup>

**64. Related to Component 2, the WB - in cooperation with the banking agencies - undertook a detailed assessment of the AQR of each bank reviewed in 2016.** This review was used to identify: (a) strengths and weaknesses of the reports individually and as a group; (b) weaknesses in the scope and application of the existing AQR methodology; and, (c) to compare the performance of the "Big Four" audit firms conducting the AQRs. The review revealed a number of deficiencies in the AQR framework used and recommendations how to address them which informed the design of this component (see Box 1.2. for further information).

**65. Component 3 was informed by the 2014 FSAP Technical Note on systemic liquidity management, financial safety net, insolvency framework, macroprudential policy<sup>13</sup> which revealed the need to establish a resolution authority.** At present, FBA and BARS have some resolution powers but are not formally designated as, or equipped, to be resolution authorities. Supported by the IMF and the

<sup>12</sup> <https://www.bankingsupervision.europa.eu/about/ssmexplained/html/srep.en.html>.

<sup>13</sup> FSAP Technical Note on systemic liquidity management, financial safety net, insolvency framework, macroprudential policy.



WB, both entities have made amendments to their respective Banking Laws in order to establish clear responsibility for bank resolution vested with the banking agencies as well as resolution tools empowering them to take over and control a failing bank (in line with the Financial Sector Board Key Attributes for Effective Resolution Regimes and aligned with the European BRRD). However, while the new Banking Laws represent a major achievement, it will take several years for the new resolution framework to be fully implemented. Thus the project will support the setup of Resolution Units, implementation of associated regulations for the laws, and the operationalization of recovery and resolution planning.

**66. Component 4 builds on extensive WB and international experience in reforming state-owned banks and development banks.** An assessment conducted by the WB in Fall 2016 of the Entity development banks revealed that - while RFBiH and IRBRS differ in terms of operations conducted and in their size - they both face significant weaknesses with regard to their institutional and governance arrangements. In general, the RFBiH's overly wide mandate creates a range of governance concerns, and risks diffusing – and thus making less effective - the impact of the bank. It has limited organizational capacity and is inadequately supervised at the moment. The IRBRS performs several functions. They extend to development functions, the management of RS government funds, and the role of lender of last resort for the RS banking system. IRBRS and the six funds it manages should be transformed to become a genuine development bank, with well-defined developmental objectives, a clear list of eligible activities, a viable business model, and robust governance, external supervision, and risk management.

**67. Comprehensive corporate governance reforms, proper banking supervision, and reinforcing the ownership function are necessary.** The main points of the assessment which informed the design of this component are outlined below:

- **Corporate governance reforms include *inter alia*** clarifying the mandates of both banks to identify and address market failures and help crowd in private sector finance, developing medium and long term strategies, strengthening the supervisory boards,<sup>14</sup> requiring the supervisory board to appoint committees in line with international best practice, e.g. an audit committee and a risk committee (instead of the separate audit boards), reinforcing the executive board and management structure,<sup>15</sup> introducing robust and proper risk management, boosting the internal audit function with adequate staffing, and in general increasing transparency of their operations.
- **Both banks should be supervised by their respective Entity banking agency, along similar lines as commercial banks, but with limited exemptions reflecting their funding model.** Clear prudential requirements (e.g. capital adequacy) should be set to safeguard contingent fiscal liabilities. Moreover, it is recommended that working groups should be established to prepare for supervision of both development banks by the banking agencies. This is particularly urgent for IRBRS because it has been exempt from any external banking supervision from its inception (RFBiH has been supervised with some limitations on the scope of supervision and only indirect enforcement by means of recommendations from the FBA to its respective government).
- **The ownership function of the entity governments should be overhauled in both banks,** and a clear process of setting their mid-term and long-term performance should be established. An

<sup>14</sup> This includes ensuring a majority of independent members, with adequate skills, competitive remuneration, and staggered terms.

<sup>15</sup> This includes ensuring more detailed criteria for selecting executive board members, with adequate financial skills, competitive remuneration, and staggered terms.



evaluation methodology and key performance indicators should be developed to assess the banks' performance and to hold the supervisory board and management board more accountable for results.

**C. Financial Management**

**68. An assessment of financial management capacity was carried out by the WB in December 2016, and updated in February 2017 during the appraisal mission.** The assessment concluded that the financial management arrangements for the project, subject to compliance with financial management conditions, are acceptable to the Bank and that the overall financial management risk is moderate with the application of the mitigation measures.

**69. The PITs will be established in the entity MoFs, and such PITs will maintain financial management systems acceptable to the WB.** The project financial statements will be audited by independent auditors acceptable to the Bank and on terms of reference acceptable to the WB. The annual audited financial statements and the audit reports will be provided to the WB within six months of the end of each fiscal year. The project financial audit will also include an independent Disbursement Linked Results (DLR) Audit which shall certify the extent to which the DLRs for the pertinent calendar year covered by the DLR Audit have been met; and no later than six (6) months after the end of each calendar year, Ministry of Finance and Treasury (MoFT) furnishes to the WB a complete DLR Audit Report satisfactory to the WB, including all the findings and results from the DLR Audit, as well as any additional certifications from the DLR Audit as the WB may reasonably request.

**70. The PITs shall also prepare and furnish to the WB not later than forty-five (45) days after the end of each calendar quarter, interim unaudited financial reports for the project covering the quarter, in form and substance satisfactory to the Bank.**

**71. In order to improve the existing financial management arrangements an action plan had been agreed:**

Action	Responsible	Timeline
Project Operations Manuals (POMs) will include a section relating to the financial management of the project.	All implementing Ministries/institutions	Draft to be received before negotiations, final adopted version due by effectiveness
The MoFs assign or hire relevant project management and FM staff for PITs.	entity MoFs	At least one entity before project effectiveness (effectiveness condition) and the other entity before first disbursement under its corresponding disbursement categories (disbursement condition)
The Borrower shall promptly inform the WB of any changes, or proposed changes, to fiduciary arrangements relating to	All Ministries included	Covenant: As soon as any changes are proposed to



Action	Responsible	Timeline
the Eligible Expenditure Program (EEP), and shall provide to the WB all such information and evidence as the WB may require to assess the fiduciary procedures and processes, as further set forth in the POMs	in the project	fiduciary arrangements relating to the EEP
Preparation and submission of audited project financial statements. The scope of financial audits will include reviews of claims made for reimbursement of eligible expenditures during the period covered by the audit.	entity MoFs	Covenant: Within 6 months after the end of each financial year
FM supervision plan to include review of arrangements related to EEP relevant expenditures.	Bank Task Team	During project implementation support/supervision

**D. Procurement**

**72.** Procurement under the portion of the project that will disburse based on traditional investment lending procedures will be carried out in accordance with the WB ‘Guidelines: Procurement of Goods, Works, and Non-Consulting Services under IBRD Loans and IDA Credits & Grants by World Bank Borrowers’, published in January 2011 and revised in July 2014, (Procurement Guidelines) and ‘Guidelines: Selection and Employment of Consultants under IBRD Loans and IDA Credits & Grants by World Bank Borrowers’, published in January 2011 and revised in July 2014, (Consultant Guidelines) and with the latest Guidelines on Preventing and Combating Fraud and Corruption in Projects Financed by IBRD Loans and IDA Credits and Grants. The capacity of each entity to implement technical assistance activities has been assessed and reflected in Procurement Risk Assessment and Management System. The team assessed the risks that may negatively affect the ability of the implementing agencies (IAs) to carry out technical assistance selection processes for Part A.5 and B.5 of the project. Each of the IAs will be responsible for implementation of their respective parts of the project and will report to the WB. Each ministry will also establish PITs consisting of individual consultants as necessary that will provide fiduciary support for selection of consultants’ services and management of consultants’ contracts. It is expected that only consultants, non-consultant services, and goods may be procured under potential technical assistance component, if required. If this component is not triggered, such amount can be reallocated to other components under DLRs. Considering the risks identified, their mitigation measures and the proposed implementation arrangements, the overall risk for procurement is considered Moderate.

**E. Social (including Safeguards)**

**73.** **The project does not expect to have negative social effects.** The proposed components aim to improve the enabling environment for households and enterprises to get access to finance by mainly focusing on improving institutional, regulatory and supervisory frameworks for the banking sector. It is unlikely and unforeseeable that any particular social groups will be negatively affected.



**74. Citizen Engagement.** Public consultations on drafting legislation are required by law in BiH. Regulation on Consultations in Legislative Drafting (published in the “Official Gazette of BiH”, no 81/06 and 80/14) guides procedures for consultations with general public and organizations that are mandatory for all ministries and other institutions when drafting any legislative acts. The banking agencies make all draft bylaws available on their websites. The project will work with the Agencies to ensure that a log is kept for the number of comments or suggestions to draft bylaws received, and how these have been incorporated. In addition, the CBBH is publishing financial data and other relevant information about the banking sector on a regular basis to inform and facilitate feedback from the general public. Jointly with USAID, the CBBH launched on its website the Educational Component to promote financial literacy and thus increase public awareness and participation in the consultations on legislative changes.

**75. Gender:** There are no gender inequalities in areas of direct relevance to the project because the project deals with the banking regulatory and supervisory framework and not end users. The project has therefore limited direct impact on end users of the banking system, which is where some gender disparities are still found. Nevertheless, reforms to strengthen and further develop the financial system may indirectly contribute to including underrepresented groups, such as women, in the financial sector. Limited available data suggests that females are less included in the financial system than men in BiH with a lower share having an account or savings in a financial institution.<sup>16</sup>

**76. Social Safeguards:** Operational Policy 4.12 on Involuntary Resettlement will not be triggered as the project does not include civil works and land acquisition will not occur.

#### **F. Environment (including Safeguards)**

**77. The project does not trigger any WB environmental safeguards policies. Therefore, the project has been assigned a Category ‘C’ in accordance with the WB safeguard policy OP/BP/GP 4.01.**

#### **G. Other Safeguard Policies (if applicable)**

N/A

#### **H. World Bank Grievance Redress**

**78.** Communities and individuals who believe that they are adversely affected by a WB supported project may submit complaints to existing project-level grievance redress mechanisms or the WB’s Grievance Redress Service (GRS). The GRS ensures that complaints received are promptly reviewed in order to address project-related concerns. Project affected communities and individuals may submit

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<sup>16</sup> In more detail, women lag behind men when it comes to financial inclusion in certain aspects. According to the Bank’s global FINDEX database, in 2014, an estimated 59 percent of men in BiH had access to a bank account compared to 47 percent of women. Women also lag behind men with regard to access to savings accounts, with only 6 percent of women reporting savings within the last year compared to 12 percent of men. Borrowing from financial institutions has been growing, with no significant gender gaps in borrowing patterns. In fact, in 2014, women were ahead when it comes to borrowing at a formal financial institution with about 16 percent compared to 12 percent of men.



their complaint to the WB's independent Inspection Panel which determines whether harm occurred, or could occur, as a result of WB non-compliance with its policies and procedures. Complaints may be submitted at any time after concerns have been brought directly to the WB's attention, and WB Management has been given an opportunity to respond. For information on how to submit complaints to the WB's corporate GRS, please visit <http://www.worldbank.org/en/projects-operations/products-and-services/grievance-redress-service>. For information on how to submit complaints to the WB Inspection Panel, please visit [www.inspectionpanel.org](http://www.inspectionpanel.org).



**VII. RESULTS FRAMEWORK AND MONITORING**

**Results Framework**

**COUNTRY : Bosnia and Herzegovina**  
**Banking Sector Strengthening Project**

**Project Development Objectives**

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

**Project Development Objective Indicators**

Indicator Name	Core	Unit of Measure	Baseline	End Target	Frequency	Data Source/Methodology	Responsibility for Data Collection
<b>Name:</b> PDI 1.a. (FBiH): All FBiH banks remain well-capitalized		Text	No	Yes	Annual	Project Reports	FBA/FBiH MoF

**Description:** PDI 1.a. and 1.b.:

This indicator is split into two sub-indicators to reflect a continuous measure of adequate capitalization of FBiH banks (defined as meeting the regulatory capital adequacy requirements) including following completion of asset quality reviews of all banks in FBiH. For banks that do not comply with the regulatory minimum, FBA performs its legally mandated function through either mandating the bank to have in place, and implement, a time bound corrective action program, or initiating the resolution process.

Efficiently means that FBA takes action within 90 days from the date that the supervisor establishes that the respective bank violates prudential norms for capital adequacy.



Indicator Name	Core	Unit of Measure	Baseline	End Target	Frequency	Data Source/Methodology	Responsibility for Data Collection
<b>Name:</b> PDI 1.b. (FBiH): FBA reviews and efficiently responds to cases when banks do not meet prudential norms for capital adequacy		Text	No	Yes	Annual	Project Reports	FBA/FBiH MoF
<p><b>Description:</b> PDI 1.a. and 1.b.:</p> <p>This indicator is split into two sub-indicators to reflect a continuous measure of adequate capitalization of FBiH banks (defined as meeting the regulatory capital adequacy requirements) including following completion of asset quality reviews of all banks in FBiH. For banks that do not comply with the regulatory minimum, FBA performs its legally mandated function through either mandating the bank to have in place, and implement, a time bound corrective action program, or initiating the resolution process.</p> <p>Efficiently means that FBA takes action within 90 days from the date that the supervisor establishes that the respective bank violates prudential norms for capital adequacy.</p>							
<b>Name:</b> PDI 2 (FBiH): FBA performing its legally mandated technical functions in bank resolution		Text	No	Yes	Annual	Project Reports	FBA/FBiH MoF
<p><b>Description:</b> This is a measure of the FBA having the capacity to perform functions that are defined in FBiH’s new legal framework for bank resolution, both in normal circumstances and in the case of a bank failure. FBA’s legally mandated technical functions that are directly related to the project’s performance include to apply if needed the resolution tools and to exercise its resolution powers as prescribed in the Banking Law including assessment of recovery plans and drawing up of resolution plans.</p>							



Indicator Name	Core	Unit of Measure	Baseline	End Target	Frequency	Data Source/Methodology	Responsibility for Data Collection
<b>Name:</b> PDI 3 (FBiH): New governance and business model for RBFBiH adopted		Text	No	Yes	Annual	Project Reports	RBFBiH/FBiH MoF
<p><b>Description:</b> RBFBiH’s new strategic business model ensures that the bank (i) operates on a financially sustainable basis, (ii) is regulated and supervised by the respective Banking Agency, (iii) operates increasingly on a wholesale basis (with new loans and guarantees extended via other BiH banks), and (iv) has a majority of independent supervisory board members.</p>							
<b>Name:</b> PDI 1.a. (RS): All RS banks remain well-capitalized		Text	No	Yes	Annual	Project Reports	BARS/RS MoF
<p><b>Description:</b> PDI 1.a. and 1.b.:</p> <p>This indicator is split into two sub-indicators to reflect a continuous measure of adequate capitalization of RS banks (defined as meeting the regulatory capital adequacy requirements) including following completion of asset quality reviews of all banks in RS. For banks that do not comply with the regulatory minimum, BARS performs its legally mandated function through either mandating the bank to have in place, and implement, a time bound corrective action program, or initiating the resolution process.</p> <p>Efficiently means that BARS takes action within 90 days from the date that the supervisor establishes that the respective bank violates prudential norms for capital adequacy.</p>							
<b>Name:</b> PDI 1.b. (RS): BARS reviews and efficiently responds to cases when banks do not meet prudential norms for capital adequacy		Text	No	Yes	Annual	Project Reports	BARS/RS MoF



Indicator Name	Core	Unit of Measure	Baseline	End Target	Frequency	Data Source/Methodology	Responsibility for Data Collection
<p>Description: PDI 1.a. and 1.b.:</p> <p>This indicator is split into two sub-indicators to reflect a continuous measure of adequate capitalization of RS banks (defined as meeting the regulatory capital adequacy requirements) including following completion of asset quality reviews of all banks in RS. For banks that do not comply with the regulatory minimum, BARS performs its legally mandated function through either mandating the bank to have in place, and implement, a time bound corrective action program, or initiating the resolution process.</p> <p>Efficiently means that BARS takes action within 90 days from the date that the supervisor establishes that the respective bank violates prudential norms for capital adequacy.</p>							
<b>Name:</b> PDI 2 (RS): BARS performs its legally mandated technical functions in bank resolution		Text	No	Yes	Annual	Project Reports	BARS/RS MoF
<p>Description: This is a measure of the BARS having the capacity to perform functions that are defined in RS’s new legal framework for bank resolution, both in normal circumstances and in the case of a bank failure. BARS’s legally mandated technical functions that are directly related to the project’s performance include application, if needed, of the resolution tools and exercise of its resolution powers as prescribed in the Banking Law, including assessment of recovery plans and drawing up of resolution plans.</p>							
<b>Name:</b> PDI 3 (RS): New governance and business model for IRBRS adopted		Text	No	Yes	Annual	Project Reports	IRBRS/RS MoF
<p>Description: IRBRS’s new strategic business model ensures that the bank (i) operates on a financially sustainable basis, (ii) is regulated and supervised by the respective Banking Agency, (iii) operates increasingly on a wholesale basis (with new loans and guarantees extended via other BiH banks), (iv) has a majority of independent supervisory board members.</p>							

**Intermediate Results Indicators**

Indicator Name	Core	Unit of Measure	Baseline	End Target	Frequency	Data Source/Methodology	Responsibility for Data Collection
<b>Name:</b> IRI 1 (FBiH): Quantitative impact study on liquidity and capital regulations completed		Text	No	Yes	Annual	Verification Protocol for DLI 1.1	FBA/FBiH MoF
Description: FBA completes QIS on liquidity and capital regulations and publishes results on its website.							
<b>Name:</b> IRI 2 (FBiH): Bylaws adopted on (i) capital; (ii) liquidity; (iii) risk management standards; (iv) ICAAP; and (v) consolidated supervision		Text	No	Yes	Annual	Verification Protocol for DLI 1.2	FBA/FBiH MoF
Description: FBA adopts bylaws on i) capital; (ii) liquidity; (iii) risk management standards, including risk appetite framework and internal governance; (iv) internal capital adequacy assessment process (ICAAP); and (v) consolidated supervision.							
<b>Name:</b> IRI 3 (FBiH): Adoption of new risk-based supervisory review and evaluation process (SREP) methodology aligned with with EU (European Banking Authority EBA) standards		Text	No	Yes	Annual	Verification Protocol for DLI 1.3	FBA/FBiH MoF



Indicator Name	Core	Unit of Measure	Baseline	End Target	Frequency	Data Source/Methodology	Responsibility for Data Collection
Description: FBA adopts new risk based SREP methodology aligned with EU (EBA) standards.							
<b>Name:</b> IRI 4 (FBiH): FBA (i) adopted a harmonized 2017 AQR framework; (ii) approved the final reports of AQRs of all banks in FBiH not previously subject to an AQR based on the harmonized 2017 AQR framework.		Text	No	Yes	Annual	Verification Protocol for DLI 2.1	FBA/FBiH MoF
Description: FBA approves AQRs undertaken in 2017 for all banks not previously subject to an AQR based on harmonized 2017 AQR framework developed and adopted with support of the WB.							
<b>Name:</b> IRI 5 (FBiH): All undercapitalized banks have in place either mandatory time bound corrective action programs or resolution/liquidation programs		Text	No	Yes	Annual	Verification Protocol for DLI 2.2/2.3	FBA/FBiH MoF
Description: All undercapitalized banks stemming from the 2017 AQR have in place either mandatory time bound corrective action programs or resolution/liquidation programs approved by FBA.							
<b>Name:</b> IRI 6 (FBiH): Bylaw on recovery plans adopted by		Text	No	Yes	Annual	Verification Protocol for DLI 3.1	FBA/FBiH MoF



Indicator Name	Core	Unit of Measure	Baseline	End Target	Frequency	Data Source/Methodology	Responsibility for Data Collection
FBA							
Description: Following the adoption of the Federation Banking Law and Banking Agency Law, FBA adopts bylaw on recovery plans.							
<b>Name:</b> IRI 7 (FBiH): Resolution unit in FBA established and made operational		Text	No	Yes	Annual	Verification Protocol for DLI 3.2	FBA/FBiH MoF
Description: Following the adoption of the Federation Banking Law and Banking Agency Law, FBA establishes and makes operational a resolution unit which is adequately resourced and staffed as well as organizationally and functionally independent from supervision.							
<b>Name:</b> IRI 8 (FBiH): Number of recovery plans submitted and assessed in line with internal assessment methodology		Number	0.00	15.00	Annual	Verification Protocol for DLI 3.3	FBA/FBiH MoF
Description: FBA assesses recovery plans submitted by all FBiH banks in line with newly developed internal assessment methodology.							
<b>Name:</b> IRI 9 (FBiH): FBiH Government to approve a strategic statement for RBFBIH future development		Text	No	Yes	Annual	Verification Protocol for DLI 4.1	FBiH MoF
Description: FBiH Government approves a strategic statement for RBFBIH's future development foreseeing that the bank will: comply with the Banking Law and will be supervised by the Federation Banking Agency (FBA) under a regulatory scheme adapted to the bank's funding model; operate on a financially sustainable basis; conform							



Indicator Name	Core	Unit of Measure	Baseline	End Target	Frequency	Data Source/Methodology	Responsibility for Data Collection
to the regulations of the FBA in the structure of governance and risk management of the bank; and operate predominantly as a wholesale institution.							
<b>Name:</b> IRI 10 (FBiH): RBFBiH's business plan for 2018-20 approved by the Shareholders Assembly		Text	No	Yes	Annual	Verification Protocol for DLI 4.2.a	RBFBiH/FBiH MoF
Description: Shareholders Assembly of RBFBiH approves business plan for 2018-2020 in line with the FBiH Government's strategic statement for the development bank.							
<b>Name:</b> IRI 11 (FBiH): RBFBiH's risk management strengthened		Text	No	Yes	Annual	Verification Protocol for DLI 4.3.a	RBFBiH/FBiH MoF
Description: RBFBiH adopts measures to fully align its risk management organization, reporting lines, and policies and procedures with those required for FBA-regulated banks.							
<b>Name:</b> IRI 12 (FBiH): Citizen Engagement: % of Project-supported bylaws reflecting outcomes of consultations.		Percentage	0.00	100.00	Annual	Progress Reports	PIT/FBA
Description: FBA makes all draft bylaws available on its website. This indicator measures the percent of bylaws supported by the project which were adopted after consultations with stakeholders. A log will be kept by FBA for the number of comments or suggestions received.							
<b>Name:</b> IRI 1 (RS): Quantitative impact study on liquidity and capital		Text	No	Yes	Annual	Verification Protocol for DLI 1.1	BARS/RS MoF



Indicator Name	Core	Unit of Measure	Baseline	End Target	Frequency	Data Source/Methodology	Responsibility for Data Collection
regulations completed.							
Description: BARS completes QIS on liquidity and capital regulations and publishes results on its website.							
<b>Name:</b> IRI 2 (RS): Bylaws adopted on (i) capital; (ii) liquidity; (iii) risk management standards; (iv) ICAAP; and (v) consolidated supervision		Text	No	Yes	Annual	Verification Protocol for DLI 1.2	BARS/RS MoF
Description: BARS adopts bylaws on i) capital; (ii) liquidity; (iii) risk management standards, including risk appetite framework and internal governance; (iv) internal capital adequacy assessment process (ICAAP), and (v) consolidated supervision.							
<b>Name:</b> IRI 3 (RS): Adoption of new risk based SREP methodology aligned with EU (EBA) standards		Text	No	Yes	Annual	Verification Protocol for DLI 1.3	BARS/RS MoF
Description: BARS adopts new risk based SREP methodology aligned with EU (EBA) standards.							
<b>Name:</b> IRI 4 (RS): BARS (i) adopted a harmonized 2017 AQR framework; (ii) approved the final reports of AQRs of all banks in RS not previously subject to an AQR based on the harmonized		Text	No	Yes	Annual	Verification Protocol for DLI 2.1	BARS/RS MoF



Indicator Name	Core	Unit of Measure	Baseline	End Target	Frequency	Data Source/Methodology	Responsibility for Data Collection
2017 AQR framework.							
<p><b>Description:</b> BARS approves AQRs undertaken in 2017 for all banks not previously subject to an AQR based on harmonized 2017 AQR framework developed with support of the WB.</p>							
<b>Name:</b> IRI 5 (RS): All undercapitalized banks have in place either mandatory time bound corrective action programs or resolution/liquidation programs		Text	No	Yes	Annual	Verification Protocol for DLI 2.2/2.3	BARS/RS MoF
<p><b>Description:</b> All undercapitalized banks stemming from the 2017 AQR have in place either mandatory time bound corrective action programs or resolution/liquidation programs approved by BARS.</p>							
<b>Name:</b> IRI 6 (RS): Bylaw on recovery plans adopted by BARS		Text	No	Yes	Annual	Verification Protocol for DLI 3.1	BARS/RS MoF
<p><b>Description:</b> Following the adoption of the RS Banking Law and RS Banking Agency Law, BARS adopts bylaw on recovery plans.</p>							
<b>Name:</b> IRI 7 (RS): Resolution unit in BARS established and made operational		Text	No	Yes	Annual	Verification Protocol for DLI 3.2	BARS/RS MoF



Indicator Name	Core	Unit of Measure	Baseline	End Target	Frequency	Data Source/Methodology	Responsibility for Data Collection
<p><b>Description:</b> Following the adoption of the RS Banking Law and RS Banking Agency Law, BARS establishes and makes operational a resolution unit which is adequately resourced and staffed as well as organizationally and functionally independent from supervision.</p>							
<b>Name:</b> IRI 8 (RS): Number of recovery plans submitted and assessed in line with internal assessment methodology		Number	0.00	8.00	Annual	Verification Protocol for DLI 3.3	BARS/RS MoF
<p><b>Description:</b> BARS assesses recovery plans submitted by all RS banks in line with newly developed internal assessment methodology.</p>							
<b>Name:</b> IRI 9 (RS): Approval by the RS Government of a statement governing IRBRS's future development.		Text	No	Yes	Annual	Verification Protocol for DLI 4.1	RS MoF
<p><b>Description:</b> RS Government approves a strategic statement for IRBRS' future development foreseeing that the bank will operate on a financially sustainable basis; the structure of governance and risk management of the bank will conform to the regulations BARS; and the bank will operate as a wholesale institution.</p>							
<b>Name:</b> IRI 10 (RS): Transfer of identified Funds' assets to IRBRS in compliance with (i) amended IRBRS Law and (ii) IRBRS regulations and BARS bylaw governing the application of banking regulations to IRBRS.		Text	No	Yes	Annual	Verification Protocol for DLI 4.2.b	RS MoF



Indicator Name	Core	Unit of Measure	Baseline	End Target	Frequency	Data Source/Methodology	Responsibility for Data Collection
<p><b>Description:</b> Transfer of identified Funds’ assets aligned with IRBRS’ strategy to IRBRS in compliance with (i) amended IRBRS Law specifying IRBRS’ revised mandate, and (ii) IRBRS regulations and BARS bylaw governing the application of banking regulations to IRBRS.</p>							
<p><b>Name:</b> IRI 11 (RS): IRBRS in full compliance with BARS bylaw governing the application of banking regulations to IRBRS.</p>		Text	No	Yes	Annual	Verification Protocol for DLI 4.3.b	IRBRS/ RS MoF
<p><b>Description:</b> IRBRS adopts measures to align its regulations with applicable BARS regulation.</p>							
<p><b>Name:</b> IRI 12 (RS): Citizen Engagement: % of Project-supported bylaws reflecting outcomes of consultations.</p>		Percentage	0.00	100.00	Annual	Progress Reports	PIT/BARS
<p><b>Description:</b> BARS makes all draft bylaws available on its website. This indicator measures the percent of bylaws supported by the project which were adopted after consultations with stakeholders. A log will be kept by BARS for the number of comments or suggestions received.</p>							



**Target Values**

**Project Development Objective Indicators**

Indicator Name	Baseline	YR1	YR2	YR3	End Target
PDI 1.a. (FBiH): All FBiH banks remain well-capitalized	No	No	No	No	Yes
PDI 1.b. (FBiH): FBA reviews and efficiently responds to cases when banks do not meet prudential norms for capital adequacy	No	No	No	No	Yes
PDI 2 (FBiH): FBA performing its legally mandated technical functions in bank resolution	No	No	No	No	Yes
PDI 3 (FBiH): New governance and business model for RBFBIH adopted	No	No	No	No	Yes
PDI 1.a. (RS): All RS banks remain well-capitalized	No	No	No	No	Yes
PDI 1.b. (RS): BARS reviews and efficiently responds to cases when banks do not meet prudential norms for capital adequacy	No	No	No	No	Yes
PDI 2 (RS): BARS performs its legally mandated technical functions in bank resolution	No	No	No	No	Yes
PDI 3 (RS): New governance and business model for IRBRS adopted	No	No	No	No	Yes

**Intermediate Results Indicators**

Indicator Name	Baseline	YR1	YR2	YR3	End Target
IRI 1 (FBiH): Quantitative impact study on liquidity and capital regulations completed	No	Yes	Yes	Yes	Yes
IRI 2 (FBiH): Bylaws adopted on (i) capital; (ii) liquidity; (iii) risk management standards; (iv) ICAAP; and (v) consolidated supervision	No	No	Yes	Yes	Yes
IRI 3 (FBiH): Adoption of new risk-based supervisory review and evaluation process (SREP) methodology aligned with with EU (European Banking Authority EBA) standards	No	No	No	Yes	Yes
IRI 4 (FBiH): FBA (i) adopted a harmonized 2017 AQR framework; (ii) approved the final reports of AQRs of all banks in FBiH not previously subject to an AQR based on the harmonized 2017 AQR framework.	No	Yes	Yes	Yes	Yes
IRI 5 (FBiH): All undercapitalized banks have in place either mandatory time bound corrective action programs or resolution/liquidation programs	No	No	Yes	Yes	Yes
IRI 6 (FBiH): Bylaw on recovery plans adopted by FBA	No	Yes	Yes	Yes	Yes
IRI 7 (FBiH): Resolution unit in FBA established and made operational	No	No	Yes	Yes	Yes
IRI 8 (FBiH): Number of recovery plans submitted and assessed in line with internal assessment	0.00	0.00	8.00	15.00	15.00



Indicator Name	Baseline	YR1	YR2	YR3	End Target
methodology					
IRI 9 (FBIH): FBIH Government to approve a strategic statement for RBFBIH future development	No	Yes	Yes	Yes	Yes
IRI 10 (FBIH): RBFBIH's business plan for 2018-20 approved by the Shareholders Assembly	No	No	Yes	Yes	Yes
IRI 11 (FBIH): RBFBIH's risk management strengthened	No	No	No	Yes	Yes
IRI 12 (FBIH): Citizen Engagement: % of Project-supported bylaws reflecting outcomes of consultations.	0.00	0.00	0.00	0.00	100.00
IRI 1 (RS): Quantitative impact study on liquidity and capital regulations completed.	No	Yes	Yes	Yes	Yes
IRI 2 (RS): Bylaws adopted on (i) capital; (ii) liquidity; (iii) risk management standards; (iv) ICAAP; and (v) consolidated supervision	No	No	Yes	Yes	Yes
IRI 3 (RS): Adoption of new risk based SREP methodology aligned with EU (EBA) standards	No	No	No	Yes	Yes
IRI 4 (RS): BARS (i) adopted a harmonized 2017 AQR framework; (ii) approved the final reports of AQRs of all banks in RS not previously subject to an AQR based on the harmonized 2017 AQR framework.	No	Yes	Yes	Yes	Yes
IRI 5 (RS): All undercapitalized banks have in place either mandatory time bound corrective action	No	No	Yes	Yes	Yes



Indicator Name	Baseline	YR1	YR2	YR3	End Target
programs or resolution/liquidation programs					
IRI 6 (RS): Bylaw on recovery plans adopted by BARS	No	Yes	Yes	Yes	Yes
IRI 7 (RS): Resolution unit in BARS established and made operational	No	No	Yes	Yes	Yes
IRI 8 (RS): Number of recovery plans submitted and assessed in line with internal assessment methodology	0.00	0.00	4.00	8.00	8.00
IRI 9 (RS): Approval by the RS Government of a statement governing IRBRS's future development.	No	Yes	Yes	Yes	Yes
IRI 10 (RS): Transfer of identified Funds' assets to IRBRS in compliance with (i) amended IRBRS Law and (ii) IRBRS regulations and BARS bylaw governing the application of banking regulations to IRBRS.	No	No	Yes	Yes	Yes
IRI 11 (RS): IRBRS in full compliance with BARS bylaw governing the application of banking regulations to IRBRS.	No	No	No	Yes	Yes
IRI 12 (RS): Citizen Engagement: % of Project-supported bylaws reflecting outcomes of consultations.	0.00	0.00	0.00	0.00	100.00



## ANNEX 1: DETAILED PROJECT DESCRIPTION

**COUNTRY: Bosnia and Herzegovina**  
**Banking Sector Strengthening Project**

### **A. Project Design and Rationale**

**1. The project aims to support the authorities in BiH in their efforts to build a stable, efficient, and inclusive banking sector.** For BiH to grow at a higher and sustainable level, the country needs to rebalance its economy, most notably by unleashing the potential of the private sector and by shifting from an inward focus to a stronger international integration through investments and exports. Better conditions for businesses are needed for them to set up, grow and invest, create jobs, and export. A stable, efficient and accessible financial sector is an essential pre-condition for private sector-led economic growth and shared prosperity.

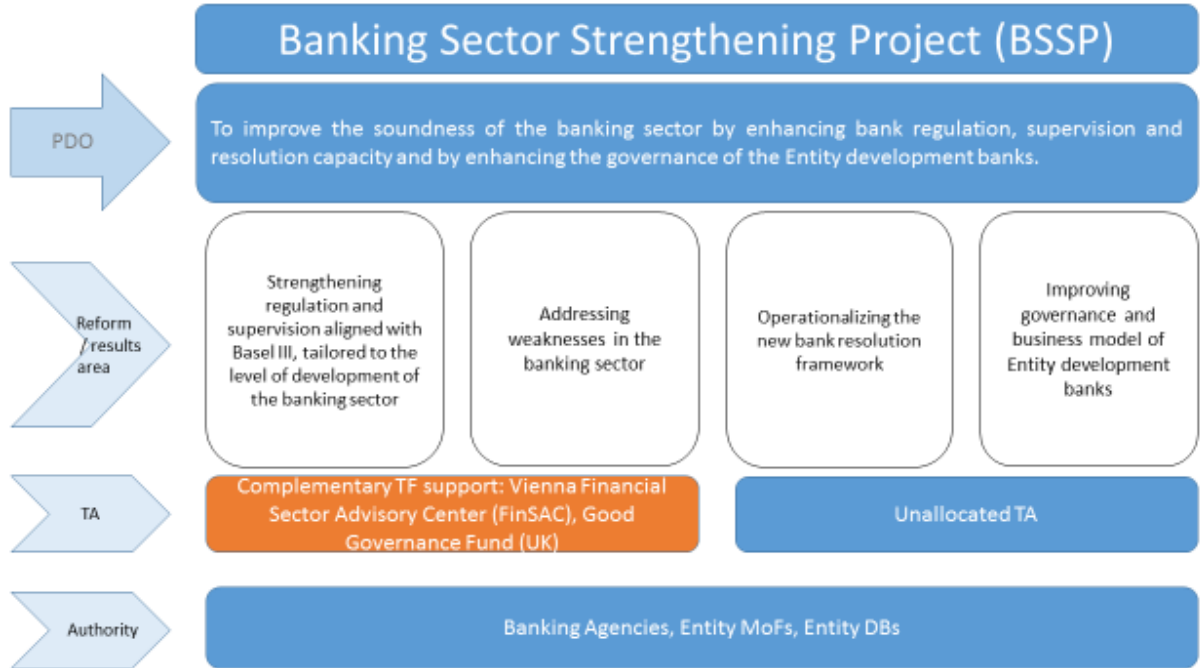
**2. The project focuses on supporting the authorities in implementation of key banking sector reforms identified in the Authorities' Medium Term Reform Agenda, in the banking agencies' FSAP implementation action plans, and in the Authorities' requests for assistance from the WB.** Complementary technical assistance to support the authorities to achieve the goals set forth in the reform agendas and action plans would also be provided by the WB to BiH in particular via FinSAC funded by the Austrian government and with trust fund resources from the UK. These reforms will help maintain the stability of the financial sector and macro-fiscal stability.

**3. The project design is uniquely tailored to ensure that activities proposed for the banking sector are fully harmonized between the entities in line with the reform agenda and 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.

### **B. Project Components and Key Results Areas**

**4. In addition to the project description provided in the main text, this section gives a detailed description of project components and results areas.**

**Figure 1.1: Overview of proposed project design**



5. The project is built 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 in both entities (see Box 1.1). 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 (see Box 1.1 for overview of key FSAP recommendations). These areas have been selected based on the strategic relevance of the reform areas and specific requests from the authorities for WB assistance. The selection of reform areas also takes into account gaps in assistance and areas already being supported by other development partners. Complementary technical assistance to support the authorities to achieve the goals set forth in the program will be provided by the WB with trust fund assistance. 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 portion of the loan is therefore set aside for technical assistance and operational costs (Component 5).



**Box 1.1: 2014 FSAP recommendations**

<p>The FSAP which was jointly conducted by IMF and WB in 2014 revealed a number of vulnerabilities in the financial sector in BiH. Although the banking system - dominated by foreign banks - appears broadly sound, significant pockets of vulnerability exist among domestically-owned banks. A number of those banks are struggling to meet capital requirements with NPLs remaining high. Concentration risks faced by domestic banks are high with some relying heavily on public sector support. Moreover, significant deficiencies remain in the financial safety net, including in respect to resolution powers, institutional responsibility for resolution and resolution funding.</p>	
<b>Key FSAP Recommendations and Authority Responsible for Implementation</b>	<b>Time<sup>17</sup></b>
<b>Banking Oversight</b>	
Develop a remedial action program focusing on new tools, earlier step-up enforcement, and heavier fines to expedite corrective action (FBA, BARS, relevant Ministries of Finance and Justice).	NT
Strengthen provisioning under IAS by issuing standards to encourage conservative assumptions on impairment by banks (FBA, BARS).	MT
Enact new Laws on Banks and amend relevant legislation addressing deficiencies in supervisory powers, consolidated supervision, and identification of ultimate beneficiary owners (FBA, BARS, CBBH, Ministries).	I
Conduct additional AQRs in banks with weak solvency and liquidity indicators (FBA, BARS).	I
Assure that banks continue implementing IFRS and external auditor implement IAS (FBA, BARS).	MT
<b>Financial Safety Net, Resolution of NPLs, and Systemic Liquidity Management</b>	
Revise the reserve requirements, maturity mismatch, and the liquidity ratio (CBBH, FBA, BARS).	NT
Design and implement the LCR, adapted to BiH (FBA, BARS).	MT
Revise the consequences to banks for not complying with reserve requirement (CBBH).	MT
Enable prompt depositor pay-out (DIA).	I
Provide resolution powers to the FBA and BARS for banks in their respective jurisdictions on the new Laws on Banks, following the FSB Key Attributes and EU BRRD (FBA, BARS, DIA, relevant Ministries)	I
Broaden the scope to draw on the existing DIF for funding bank resolution using least-cost solution (DIA)	I
Establish a Financial Stability Fund (FSF)—under the DIA—to provide for open bank resolution and limited and temporary liquidity support in systemic crisis (DIA, CBBH, FBA, BARS, Authorities).	MT
Strengthen, regularly review, and test bank contingency plans of SCFS members (SCFS).	I
Strengthen the cooperation between DIA and financial safety net players (DIA, CBBH, FBA, BARS).	I
Add macroprudential analysis and policy to the coordination MoU. Define and collect additional information for the assessment of vulnerabilities and macroprudential tools (CBBH, FBA and BARS).	NT
Streamline collateral execution procedures by allowing a final auction at no reserve price if previous rounds of auctions failed and specify realistic criteria for asset market values (RS/FBiH Ministry of Justice).	I
Consider tools and incentives to facilitate restructurings and debt resolution as well as adoption of out-of-court restructuring guidelines. (RS/FBiH/BiH MoF, FBA, BARS).	I
Revise the insolvency framework by introducing incentives to initiate proceedings early and expand the insolvency framework to cover businesses run by individuals. (RS/FBiH MoJ).	NT
<b>Public Bank Governance – State-owned commercial and development banks</b>	
Modify the selection criteria for supervisory board members at public commercial and development banks to enable accountability of bank management. (FBiH MoF, RS MoF, IRBRS).	I
Assign specific responsibility to the supervisory board to strengthen its internal audit function. (FBiH MoF, RS MoF, IRBRS).	I

<sup>17</sup> I-Immediate” is within one year; “NT-near-term” is 1–3 years; “MT-medium-term” is 3–5 years.



Strengthen the ownership role conducted by the IRBRS by dedicating institutional resources to focus specifically on monitoring financial sector exposures, evaluating institutional performance, mitigating risks and defining an exit strategy for each equity or debt exposure. (RS MoF, IRBRS)	I
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***DLI 1. Strengthen bank regulation and supervision aligned with the Basel III regime, tailored to the level of development of the banking sector***

**6. Since 2008, the banking agencies of FBiH and RS have made progress in enhancing their regulatory framework and supervisory processes.** The current regulatory and supervisory frameworks are mainly based on Basel I requirements blended with some elements of Basel II and Basel III, including provisions for phasing in a fully-fledged Basel III regime. As part of the introduction of the new regulatory framework, both agencies have published draft decisions on: (i) capital and leverage, (ii) liquidity, (iii) large exposures, (iv) internal governance and risk management, (v) internal capital adequacy, and (vi) interest rate risk in the banking book. The full implementation of Basel III is expected to be introduced in 2018.

**7. The banking agencies plan to switch their supervisory reporting system from the CAMELS-based to the SREP-based methodology.** Migration to a SREP-based system will imply analyzing systematically the business model, risks to capital, risks to liquidity and the internal governance and risk management system of every bank in order to develop tailored capital and liquidity decisions for each bank. This is very different from the current supervisory system (by which CAMEL is used to rate banks according to their riskiness but not for imposing specific capital requirements). While converging to SREP-based supervision seems to be the right option to take, it needs planning and significant resources. Although part of the workload will fall under the remit of banks, the Agencies need to adapt the EU methodologies to the specific features of their banking systems.

**8. DLI 1 focuses on supporting the banking agencies in significantly strengthening banking sector regulation and supervision in line with the Basel III regime, tailored to the level of development of the banking sector.** 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 ICAAP. This will form the basis for a revised supervisory risk-based methodology aligned with the EU SREP aimed at enhancing transparency and harmonization of supervisory review processes. FinSAC technical assistance will assist the Agencies in their efforts to strengthen banking sector regulation and supervision in line with the Basel III regime, tailored to the level of development of the banking sector.

***DLI 2. Address weaknesses in the domestic banking sector***

**9. DLI 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.

**10. The project provides a follow up to the AQRs conducted for six banks under enhanced supervision in 2013.** In 2016, an additional nine AQRs (five in FBiH and four in RS) were carried out using “Big Four” audit firms to assess the condition of banks that have evidenced credit growth in excess of 10 percent from 2012 to 2014, or were under enhanced supervision in 2015, and had not already conducted AQRs. The 2016 AQRs were completed in FBiH in mid-2016 and in RS by Fall 2016. Although no immediate vulnerabilities were detected, the review of the AQR methodology revealed a number of deficiencies in the framework including quality of AQR audit firms, quality of AQRs, scoping methodology, and collateral valuation methodology. With the assistance of the WB, AQRs of all remaining banks (12 in total – 4 in RS and 8 in FBiH) are planned to be carried out using and improved AQR framework in 2017 (see Box 1.2 for further detail).

**Box 1.2: Main Improvements in 2017 AQR framework**

The 2016 AQR framework was based on a document (for the diagnostic assessment of banks during the transition period) dating back at least to 1993. As part of the revisions for the 2017 framework, supported through technical assistance delivered by the WB in collaboration with the UK Government, the new document eliminates a large amount of redundant, duplicative, and irrelevant text and as a result provides significantly clearer and comprehensible terms of reference for the AQR auditors and reduces wastage of (costly) audit staff time on tasks that are not needed for the purposes of the AQRs.

**1. Quality of AQR Audit Firms**

The review of the 2016 AQRs showed that there were very significant differences between the quality of work performed by the “Big Four” accounting firms. For the 2017 AQRs, the audit firms are now required to submit to the agencies a complete list of the staff assigned to perform AQRs, along with their qualifications and experience and time allotted to specific AQR tasks.

**2. Quality of AQRs**

The 2016 AQRs did not address the issue of the audit firms’ own quality control procedures. For the 2017 AQRs, the firms will be required: (a) to have quality control performed by a member firm from outside BiH; (b) to submit for approval a quality control plan describing the quality control process; (c) to submit for approval the names of staff, along with their qualifications and experience and time allotted to specific quality control tasks, of the foreign firm; and, (d) to submit a report on the quality control performed as part of the AQR report for each bank.

**3. Scoping Methodology for AQRs**

The scoping methodology (which determines the type, number, and value of credit exposures the auditors are required to review in an AQR) used for the 2016 AQRs dates from about 1993 and is poorly adapted for AQRs of larger banks and banks which have portfolios with a high proportion of small loans. The new scoping methodology in the 2017 AQR framework completely replaces the old methodology using a hybrid of minimum individual assessments of specific types and sizes of loans, plus a risk based selection methodology for individual assessments of further loans, plus a mandatory methodology for the statistical sampling of the remainder of the credit portfolio.

**4. AQR Collateral Valuation Methodology**



The 2016 AQR framework did not adequately address the question of how auditors should value collateral and allowed the AQR auditors to rely on the banks' own valuations. Collateral valuation is of critical importance because the main reporting principle (IAS 39) used to determine the impairment provisions required for a loan allows the offsetting of losses by the value attributed to the loan's collateral. The 2017 AQR framework has made limited but significant progress with this issue by requiring, under defined circumstances, that the AQR auditors commission new valuations of collateral which are to be performed by valuers without a business relationship with the bank concerned (and with a two-year ban on seeking business from it).

#### 5. AQR Reporting

The 2016 AQR reports were prepared in a variety of formats (essentially each audit firm using its own format) with considerable variation in the types and volume of information provided. The 2017 AQR framework addresses these problems by requiring the AQR reports to be delivered in a specified format with the content of the report's summary, and each chapter and section of the report, also specified.

**11. The project supports the banking agencies in completing the identification of weak banks using the enhanced 2017 AQR framework and follow-on enforcement actions by the supervisors.** The new framework provides better quality AQRs with a greater focus on the identification of credit risks, and has been designed to provide more targeted risk-based individual assessments of credit exposures and greater verification of collateral valuations. Support will be provided through WB monitoring of enforcement actions underway for banks with weaknesses identified by the 2015 and 2016 AQRs, by review of individual 2017 AQRs, and monitoring of enforcement actions against banks found to be undercapitalized or which have significant risk management weaknesses.

### ***DLI 3. Operationalizing the new bank resolution framework***

**12. Supported by the IMF and the WB, both entities have made amendments to their respective banking laws in order to establish clear responsibility for bank resolution vested with the banking agencies as well as resolution tools (in line with the Financial Sector Board Key Attributes for Effective Resolution Regimes and aligned with the European Bank Recovery and Resolution Directive).** In order to achieve the objectives of resolution, the resolution authorities are given four "resolution tools": the bail-in tool and three transfer tools (sale of business to a private acquirer, bridge bank, and asset separation tools). No separate resolution fund will be created in the short term so the cost of resolution will have to be borne by bailed-in liability holders, DIF and, if needed, the respective entity budgets.

**13. Implementation of the new resolution framework, will be challenging due the limitations in resources and capacity at the level of the banking agencies as new resolution authorities.** The new resolution framework foresees the establishment of a separate unit responsible for taking resolution decisions with regard to 'public interest banks' for which the normal bankruptcy procedure (liquidation) is not an option due to their complexity and or size (critical function). Even if synergies between resolution and supervision exist when they are part of the same authority, a clear functional and organizational separation should be implemented. The resolution unit should in all cases operate at arm's length and independently from other authorities and functions such as banking supervision and monetary policy. A number of bylaws will need to be adopted in order to achieve full operationalization of the bank resolution framework. Developing the skillset to apply the new powers and tools will be key,



to ensure effective and efficient use of the new framework (while recognizing capacity constraints). Supervisors will oversee the banks' recovery planning in addition to their regular duties. The new resolution units will have to develop methodologies for resolution planning including to ensure sufficient loss absorption capacity (MREL) both for the foreign-bank subsidiaries as well as "systemic" domestically owned banks. FinSAC technical assistance will support the agencies in the operationalization of the new framework with a focus on i) the establishment of the new resolution unit (staffing, internal organization (up/downstream); ii) the adoption of key by-laws; iii) the assessment of individual recovery plans; v) the adoption of a resolution manual and resolution plans including the identification of possible additional reporting needs.

**14. DLI 3 seeks to implement core elements of the new bank resolution frameworks as foreseen in the amended Banking Laws.** This results area focuses on preparation and adoption of a bylaw related recovery plans, establishment and operationalization of dedicated bank resolution units within BARS and FBA, adoption of an internal assessment methodology for recovery plans and subsequent assessment of recovery plans to be submitted by all banks to FBA and BARS.

***DLI 4. Improved governance and business model of the entity development banks***

**15. The need to restore a healthy level of growth in lending to the real sector - in particular in response to the global financial crisis - has led many countries including BiH to expand the role of state-owned financial institutions.** According to a recent EC Communication<sup>18</sup> so-called national promotional banks have an important role to play in catalyzing long-term investment and in recent years aimed to counterbalance the deleveraging process in the commercial banking sector. The effectiveness of support by these institutions depends in large part on the nature and causes of the deleveraging of commercial banks, on their ability to provide products and terms which encourage private commercial banks to scale up lending, and on the existence of a sound institutional framework for their activities. Both development banks in BiH require extensive reforms aimed primarily at institutional, operational, and corporate governance arrangements to comply to best international principles and good practices.

**16. Comprehensive corporate governance reforms, proper banking supervision, and reinforcing ownership function are necessary.** Corporate governance reforms include *inter alia* clarifying the mandates of both banks, developing medium- and long-term strategies, strengthening the supervisory boards,<sup>19</sup> requiring the supervisory board to appoint committees in line with international best practice, e.g. an audit committee and a risk committee (instead of the separate audit boards), reinforcing the executive board and management structure,<sup>20</sup> introducing independent, robust, and comprehensive risk management, boosting the internal audit function with adequate staffing, and in general increasing transparency of their operations. Both banks should be supervised by their respective Entity banking supervisor, along similar lines as commercial banks, but with some exemptions reflecting their developmental role. Clear prudential requirements (e.g. capital adequacy) should be set to safeguard

<sup>18</sup> <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52015DC0361&from=en>

<sup>19</sup> This includes ensuring a majority of independent members, with adequate skills, competitive remuneration and staggered terms.

<sup>20</sup> This includes ensuring more detailed criteria for selecting executive board members, with adequate financial skills, competitive remuneration and staggered terms.



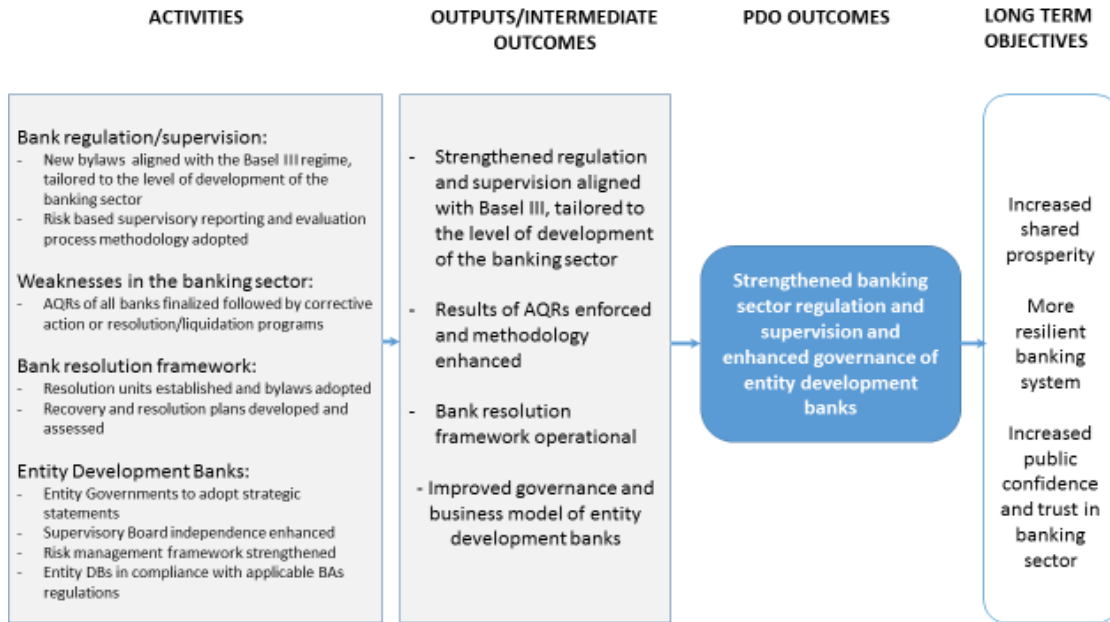
public finances. Moreover, it is recommended that working groups should be established to prepare for supervision of both development banks by the banking agencies). In particular the matter is urgent for IRBRS as it has been exempt from any external banking supervision from its foundation (RBFBiH has been supervised with some limits on the scope of supervision and only indirect enforcement).

**17. Component 4 supports strengthening of the institutional, corporate governance, and supervisory arrangements of the entity development banks and restructuring of their balance sheets.**

The results address specific steps to be taken in defining the strategic statement that will guide the future development of RBFBiH and IRBRS; transfers of assets aligned with the IRBRS' new strategy from the RS government's funds to the bank and exit of the bank from its role as manager of the funds; restriction of the banks' credit activities to primarily wholesale loans and guarantees, with direct lending limited to participation in syndicated credits to finance development projects; requirements to price the banks' financial products on a basis which results in the banks being sustainable; development by both banks of business plans focusing on implementation of their respective entity government-approved strategies; and, alignment of the banks' risk management functions, governance arrangements, reporting lines and policies and procedures with those required for FBA/BARS-regulated banks. The WB and the IMF are both providing support to entity MoFs and to the development banks to address these reforms.

**18. The project will also include a technical assistance component.** 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 in case some of the TF supported technical assistance does not fully materialize or need to be strengthened in order to ensure successful implementation of all components. This will minimize the risk and maximize impact of the project on banking sector stability and efficiency outcomes. If the additional funding for technical assistance is not needed, the portion of the financing could be reallocated to one of the other four components or cancelled.

**Figure 1.2: Results Chain**





**Table 1.1: List of Disbursement Linked Indicators (DLIs) with annual Disbursement Linked Results (DLRs)- RS**

DLIs	Disbursement Linked Results (DLRs) <sup>21</sup>		
	December 31, 2017 <sup>22</sup>	December 31, 2018	December 31, 2019
DLI 1. Strengthen bank regulation and supervision aligned with the Basel III regime tailored to the level of development of the banking sector	<p>DLR 1.1. BARS (i) completed quantitative impact study on draft regulations on liquidity and capital and (ii) published results on BARS' website.</p> <p><b>Value:</b> DLR 1.1 (i): EUR 659,625 DLR 1.1 (ii): EUR 659,625</p>	<p>DLR 1.2. BARS adopted bylaws on (i) capital; (ii) liquidity; (iii) risk management standards, including risk appetite frameworks and internal governance; (iv) internal capital adequacy assessment process (ICAAP), and (v) consolidated supervision.</p> <p><b>Value:</b> EUR 472,000 for each bylaw on a topic, up to EUR 2,360,000</p>	<p>DLR 1.3. BARS adopted new risk-based SREP-methodology aligned with EU (EBA) standards.</p> <p><b>Value:</b> EUR 2,360,000</p>
DLI 2. Address weaknesses in the domestic banking sector	<p>DLR 2.1. BARS (i) adopted a harmonized 2017 AQR framework, (ii) completed and approved final reports of AQRs of all banks not previously subject to an AQR based on</p>	<p>DLR 2.2. All undercapitalized banks have in place either mandatory time bound corrective action programs or resolution/liquidation programs.</p>	<p>DLR 2.3. All undercapitalized banks have in place either mandatory time bound corrective action programs or resolution/liquidation programs.</p>

<sup>21</sup> Dates included in these tables are approximates.

<sup>22</sup> Based on retroactive work.



	<b>Disbursement Linked Results (DLRs)<sup>21</sup></b>		
	<p>harmonized 2017 AQR framework.</p> <p><b>Value:</b> DLR 2.1(i): EUR 1,180,000 and DLR 2.1(ii): EUR 1,180,000</p>	<b>Value:</b> EUR 2,360,000	<b>Value:</b> EUR 2,360,000
DLI 3. Improve BARS' ability to undertake bank recovery and resolution functions	<p>DLR 3.1. Following adoption of the RS Banking Law and Law on RS Banking Agency, BARS adopted a bylaw on recovery plans aligned with EU (EBA) standards.</p> <p><b>Value:</b> EUR 2,360,000</p>	<p>DLR 3.2. BARS established and made operational a dedicated bank resolution unit in accordance with the new Banking Law.</p> <p><b>Value:</b> EUR 2,360,000</p>	<p>DLR 3.3. Recovery plans submitted by all banks and assessed by BARS in line with internal assessment methodology.</p> <p><b>Value:</b> EUR 2,360,000</p>
DLI 4. Improved governance and business model of RS development bank	<p>DLR 4.1. Approval by the RS Government of a strategic statement governing IRBRS's future development.</p> <p><b>Value:</b> EUR 2,360,000</p>	<p>DLR 4.2.b Transfer of identified Funds' assets aligned with IRBRS' strategy to IRBRS in compliance with (i) amended IRBRS Law specifying IRBRS' revised mandate, and (ii) IRBRS regulations and BARS bylaw governing the application of banking regulations to IRBRS.</p> <p><b>Value:</b> EUR 2,360,000</p>	<p>DLR 4.3.b IRBRS in full compliance with BARS bylaw governing the application of banking regulations to IRBRS.</p> <p><b>Value:</b> EUR 2,360,000</p>

**Table 1.2: List of Disbursement Linked Indicators (DLIs) with annual Disbursement Linked Results (DLRs)- Federation BiH**



	Disbursement Linked Results (DLRs) <sup>23</sup>		
	December 31, 2017 <sup>24</sup>	December 31, 2018	December 31, 2019
DLI 1. Strengthen bank regulation and supervision aligned with the Basel III regime tailored to the level of development of the banking sector	<p>DLR 1.1. FBA (i) completed quantitative impact study on draft regulations on liquidity and capital and (ii) published results on FBA's website.</p> <p><b>Value:</b> DLR 1.1 (i): EUR 659,625 DLR 1.1 (ii): EUR 659,625</p>	<p>DLR 1.2. FBA adopted bylaws on (i) capital; (ii) liquidity; (iii) risk management standards, including risk appetite framework and internal governance; (iv) internal capital adequacy assessment process (ICAAP), and (v) consolidated supervision.</p> <p><b>Value:</b> EUR 472,000 for each bylaw on a topic, up to EUR 2,360,000</p>	<p>DLR 1.3. FBA adopted new risk based SREP-methodology aligned with EU (EBA) standards.</p> <p><b>Value:</b> EUR 2,360,000</p>
DLI 2. Address weaknesses in the domestic banking sector	<p>DLR 2.1. FBA (i) adopted a harmonized 2017 AQR framework, (ii) completed and approved final reports of AQRs of all banks not previously subject to an AQR based on harmonized 2017 AQR framework.</p> <p><b>Value:</b> DLR 2.1(i): EUR 1,180,000 and DLR 2.1(ii): EUR 1,180,000</p>	<p>DLR 2.2. All undercapitalized banks have in place either mandatory time bound corrective action programs or resolution/liquidation programs.</p> <p><b>Value:</b> EUR 2,360,000</p>	<p>DLR 2.3. All undercapitalized banks have in place either mandatory time bound corrective action programs or resolution/liquidation programs.</p> <p><b>Value:</b> EUR 2,360,000</p>
DLI 3. Improve FBA's ability to undertake bank recovery and resolution functions	<p>DLR 3.1. Following adoption of the Federation Banking Law and Law on Federation Banking Agency, FBA adopted a bylaw on recovery plans aligned with EU (EBA) standards.</p> <p><b>Value:</b> EUR 2,360,000</p>	<p>DLR 3.2. FBA established and made operational a dedicated bank resolution unit in accordance with the new Banking Law.</p> <p><b>Value:</b> EUR 2,360,000</p>	<p>DLR 3.3. Recovery plans submitted by all banks and assessed by FBA in line with internal assessment methodology.</p> <p><b>Value:</b> EUR 2,360,000</p>
DLI 4.	DLR 4.1. FBiH Government adoption of a	DLR 4.2.a Adoption of RBFBIH's business plan	DLR 4.3.a RBFBIH's risk management

<sup>23</sup> Dates included in these tables are approximates.

<sup>24</sup> Based on retroactive work.



	<b>Disbursement Linked Results (DLRs)<sup>23</sup></b>		
	<b>December 31, 2017<sup>24</sup></b>	<b>December 31, 2018</b>	<b>December 31, 2019</b>
Improved governance and business model of FBIH development bank	strategic statement for RFBBIH's future development.  <b>Value:</b> EUR 2,360,000	for 2018-20.  <b>Value:</b> EUR 2,360,000	organization, reporting lines, and policies and procedures aligned with those required for FBA-regulated banks.  <b>Value:</b> EUR 2,360,000

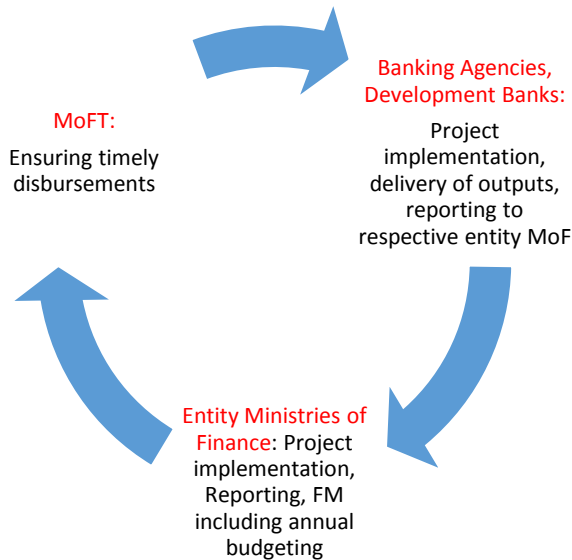
## ANNEX 2: IMPLEMENTATION ARRANGEMENTS

COUNTRY: Bosnia and Herzegovina  
Banking Sector Strengthening Project

### Project Institutional and Implementation Arrangements

- 1. The implementation arrangements are expected to be fairly straightforward as there will be a limited number of disbursements against DLIs/DLRs.** The Borrower is the MoFT which will make the respective portions of the loan proceeds available to the entity MoFs through Subsidiary Loan Agreements.
- 2. There will be small PITs at each entity MoF.** The entity MoFs will maintain adequate governance and fiduciary arrangements throughout the project implementation period. In addition, a focal point will be appointed at each of the banking agencies and the entity development banks. In summary, the roles of different stakeholders (in both entities) are as outlined in Figure 2.1.
- 3. Draft project operation manuals (POMs) describing the objectives, targets, DLR verification protocols, and organization of this operation (including FM and monitoring) will be prepared and finalized by the time of negotiations.** The final version of the POMs will be adopted by the RS and FBiH by effectiveness.

Figure 2.1.: Implementation Arrangements



*Financial Management and Disbursement Arrangements*

**4. An assessment of the financial management capacity was carried out by the WB in December 2016, and updated in February 2017 during the appraisal mission.** The assessment concluded that the financial management arrangements for the project, subject to compliance with financial management conditions, are acceptable to the WB and that the overall financial management risk is *moderate* with the application of the mitigation measures.

**5. The Project Implementation Teams.** PITs within the two entity MoFs will be responsible for the project’s overall FM and disbursements processes and will take the lead in FM arrangements of the Project. Neither PIT has yet been established and it is not clear who will be in charge of the financial management arrangements. The PITs will each include one person in charge of financial management responsibilities, as well as a project manager, and a focal point for the banking agency and development bank. The PITs will be in charge of the entire scope of financial management responsibilities for all project components, which will also be described in their Terms of Reference. In addition, the PITs will include a procurement specialist if the technical assistance component is triggered.

**6. Arrangements for the Eligible Expenditure Programs.** Implementation of all DLI-based Components will rely on Entity Governments existing financial management architecture for the salaries, social contributions, and income taxes of the relevant staff in selected institutions in the two entities. Based on quarterly IFRs prepared by the PITs, the WB will reimburse the Entity Governments for a share of salaries after specified results (DLIs) have been achieved and verified. For FBiH, budgetary allocations for salaries under budget lines 6111, 6112 and 612, and for RS budgetary allocation for salaries under budget lines 4111 and 4112 classify as eligible expenditures. Under the salaries only payments to term staff or open ended including any contributions and taxes are eligible for financing (services contracts, if any are to be excluded from the EEPs). Amounts disbursed by the WB will be included in the regular entities budget financing and expensed in accordance with entities budget policies and procedures. To enable the WB to monitor progress in releasing resources for this project, the PITs will submit quarterly reports on the execution of the EEPs under the Budgets.

<b>Agency/Institutions</b>	<b>Budget Line</b>
<b>A. Federation Bosnia and Herzegovina</b>	
House of Peoples of the Parliament of the Federation of Bosnia and Herzegovina	6111, 6112 and 612
Government of Federation of Bosnia and Herzegovina	
FBiH Ministry of Justice	
FBiH House of Representatives	
Office of the Government of FBiH for Legislation and Harmonization with European Union Regulations	
Office for public relations of the Government of FBiH	
Office for the European integrations of the government of Federation BiH	
FBiH Ministry of Finance	
<b>B. Republika Srpska</b>	
Ministry of Finance	4111, 4112
RS government	
Ministry of Justice	
Ministry of Economic Relations and Regional Cooperation	



General Secretariat of RS	
Republic Secretariat for Legislation	
RS General Assembly	
Common Services of the RS Government	

**7. The payroll system within the above mentioned FBiH and RS institutions has been subject to a financial management assessment.** All of the above institutions are included in the centralized payroll system of the Entities. The principal authorities in charge of centralized payroll processing are the Treasury departments of Entities MoF's. Such centralized payroll accounting and payroll processing has been assessed as adequate.

**8. The Office for Audit of Institutions in FBiH and Office for Audit of RS Institutions** are auditing the most materially significant institutions mentioned above and the salaries and social contributions relating to civil servant's salaries are under their regular scrutiny. For the fiscal year 2015 there were no exceptions, recommendations, or deficiencies identified for salaries and contributions in the audit reports that were issued as result of the audit of budget execution statements of the FBiH and RS budgets.

**9. Planning and Budgeting.** Each institution included in the EEP will prepare a budget for the part of the project pertaining to the specific institution and such budget will be included in the regular annual budget, as well as the medium term budget of the said institution and the PITs will be in-charge of the consolidated project budgeting and planning for each Entity.

**10. Accounting system.** Accounting systems within Entity Treasuries are assessed to be reliable and will be relied upon during project implementation. Due to limited number of transactions, the PITs will use Excel spreadsheets to record financial information related to the technical assistance part of the project, while records for parts relating to DLRs will include only relevant line items of expenditure financed by the project extracted from relevant institutions' financial reports. The preparation of the IFRs will follow the format agreed with the WB.

**11. Financial Reporting.** The PITs in MoFs will furnish to the Bank the quarterly IFRs not later than 45 days after the end of the reporting quarter. IFRs will be based on existing institutional management reports, including a summarized Entity level reconciliation prepared by the PITs. Annual financial statements will be prepared separately by the two PITs and will include all project costs. The IFRs will be prepared on the cash-basis of accounting.

**12. Quarterly IFRs for all Components (results based components) as well as the annual project financial statements will include:**

- a) IBRD Financing DLR Categories
- b) DLI and Results
- c) Explanatory Notes and Accounting Policies (only annual audited Project reports)

In addition to the above reports, for the technical assistance component the quarterly and annual financial statements will include a report on uses of funds by categories, uses of funds by component/activity and designated account reconciliation statement.

**13. Internal controls.** Internal controls will comprise, but not be limited to the following: division of responsibilities between PITs and MoFs, segregation of duties of staff within institutions participating in the project, periodic reconciliation of accounting and reporting data, and verification and authorization of reports and



documents. The key features of internal controls will be described in respective sections of the project POMs.

**14. Audit of project financial statements.** The audited project financial statements will clearly present project expenditures by each component and activity and will follow the format of the two sets of agreed IFRs with accompanying notes and explanations. The financial audit of project financial statements will be carried out by contracted auditors acceptable to the Bank in compliance with the audit terms of reference agreed with the Bank. Audited project financial statements will be transmitted to the WB by MoFT and made publicly available on its website within two months after the Bank has sent an official audit acknowledgement letter.

**15. The project financial audit will also include an independent DLRs Audit.** This shall certify the extent to which the DLRs for the pertinent calendar year covered by the DLRs audit have been met. The MoFT, no later than six (6) months after the end of each calendar year, furnishes to the Bank a complete DLR Audit Report satisfactory to the Bank, including all the findings and results from the DLRs Audit, as well as any additional certifications from the DLRs Audit as the Bank may reasonably request.

**16. Authorities' co-financing of the project.** It has been agreed that there will be no authorities' co-financing of the project.

**17. Funds flow.** To support implementation of activities under all Components, the following disbursement methods will be used:

- a) Disbursements under the DLR-linked components will use reimbursement as the only disbursement method. Such disbursements will be triggered by achievement of results, which are supported by claims for reimbursement of eligible expenditures. Achievement of the DLRs will be confirmed to the WB according to the Compliance Protocols established for each DLR agreed with the authorities. Upon confirmed achievement of a DLR the EUR amount linked to the completed DLR will be reimbursed to the entity that achieved and fulfilled the DLR. Such transfer of funds will be done directly from the loan account to the FBH or RS Entity Treasury Single Account. To initiate such transfer, the PITs will authorize an Application for Withdrawal that is subject to processing by the Minister of MoFT or his deputy and such withdrawal application is also subject to certification by the Project Task Team Leader.
- b) Disbursements under the technical assistance category will use traditional disbursement methods such as advances, direct payments, and reimbursements. For such category of expenses, the borrower will be required to open one designated account for each of the entities, and such accounts will be opened in a commercial bank acceptable to the WB. The designated accounts will be denominated in EUR currency. The following are required for requests for reimbursement and for reporting eligible expenditures paid from the Designated Account: (i) Records evidencing eligible expenditures (e.g. copies of receipts, supplier invoices) for payments for goods and non-consulting services against contracts valued at US\$100,000 equivalent or more; for consultants' services against contracts valued at US\$100,000 equivalent or more for firms, and US\$50,000 equivalent or more for individual consultants; (ii) statement of expenditure for all other expenditure/contracts, including training and incremental operating costs; (iii) list of payments against contracts that are subject to the Bank's prior review; and (iv) designated account reconciliation statement and related bank statement. For requests for Direct Payment: records evidencing eligible expenditures, e.g., copies of receipts and supplier invoices, must be submitted to the Bank.

**18.** The eligible expenditure will be documented using the statement of expenditures (SoEs) in the form of two reports following the formats of the Interim Unaudited Financial Reports (IFRs) for the results based financing



component. The two reports are (i) IBRD Financing DLR Categories and (ii) DLI and results. With respect to each DLR, there has to be evidence satisfactory to the Bank that the specific results have been attained, as per Schedules 4 and 5 of the Loan Agreement.

**19. Partial achievement.** The arrangements for partial DLR achievement are:

- Disbursements withheld due to non-achievement of DLRs in a given year may be released in subsequent years once the DLR is achieved.
- Partial achievement of a DLR (where applicable) may result in a partial disbursement on a pro rata basis (see further detail in the verification protocol in Table 2.2).
- Disbursements for any DLR will be capped at the amount allocated for that year for the concerned DLR, that is, any overachievement of a DLR will not result in any additional payments.

**20. Upon achievement of individual DLRs, the Entities may decide to withdraw the specific value assigned to that DLR or decide to withhold the disbursement until other DLRs are achieved.** In this process, the Entities will base their decision on their cash flow forecasts.

**21. Retroactive financing.** An aggregate amount up to EUR 5.66 million for the FBH and EUR 5.66 million for the RS may be made for payments made 12 months before the legal agreement signature date for eligible expenditures included in Category (1) and Category (3), respectively.

Category	Amount of the Loan Allocated (expressed in Euro)	Percentage of Expenditures to be financed (inclusive of Taxes)
(1) FBiH Eligible Expenditure Program	27,279,250	100%
(2) Goods, non-consulting services, consultants' services, Training, and Incremental Operating Costs for Part A.5 of the Project	950,000	100%
(3) RS Eligible Expenditure Program	27,279,250	100%
(4) Goods, non-consulting services, consultants' services, Training, and Incremental Operating Costs for Part B.5 of the Project	950,000	100%
(3) Front-end Fee	141,500	Amount payable pursuant to Section 2.03 of this Agreement in accordance with Section 2.07 (b) of the General Conditions
[(4)] Interest Rate Cap or Interest Rate Collar premium		[Amount due pursuant to Section 2.08(c) of this Agreement]



<b>TOTAL AMOUNT</b>	<b>56,600,000</b>	
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**22. Financial Management Covenants.** It will be required that the following covenants for the project are complied with:

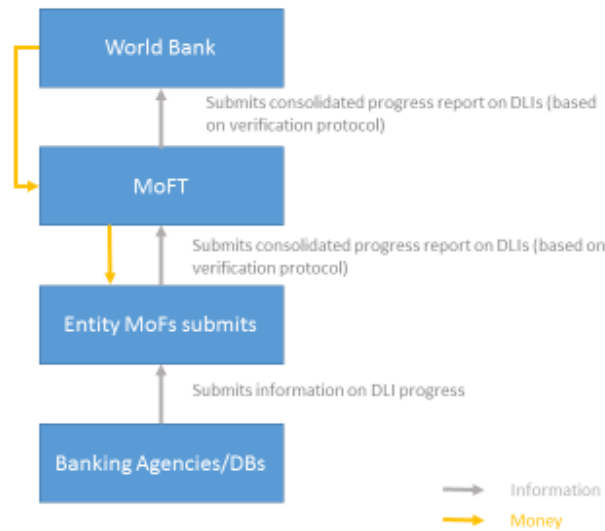
- (a) Appropriate financial management system is maintained by the client throughout implementation.
- (b) Delivery of financial reports as indicated in the financial reporting section.
- (c) Delivery of annual audits as indicated in external audit section.

**23. In order to improve the existing financial management arrangements, the following action plan had been agreed:**

<b>Action</b>	<b>Responsible</b>	<b>Timeline</b>
POMs will include a section relating to the financial management of the project.	All implementing Ministries/institutions	Draft to be received before negotiations, final adopted version due by effectiveness
The MoFs assign or hire relevant project management and FM staff for PITs.	entity MoFs	At least one entity before project effectiveness (effectiveness condition) and the other entity before first disbursement under its corresponding disbursement categories (disbursement condition)
The Borrower shall promptly inform the WB of any changes, or proposed changes, to fiduciary arrangements relating to the EEP, and shall provide to the WB all such information and evidence as the WB may require to assess the fiduciary procedures and processes, as further set forth in the POMs	All Ministries and agencies included in the project	Covenant: As soon as any changes are proposed to fiduciary arrangements relating to the EEP
Preparation and submission of audited project financial statements. The scope of financial audits will include reviews of claims made for reimbursement of eligible expenditures during the period covered by the audit.	entity MoFs	Covenant: Within 6 months after the end of each financial year
FM supervision plan to include review of arrangements related to EEP relevant expenditure.	Bank Task Team	During project implementation support/supervision

**24. Implementation Support and Supervision Plan.** During project implementation, the Bank will supervise the project’s financial management arrangements in two main ways: (i) review the project’s interim un-audited financial reports, as well as the annual audited financial statements and auditor’s management recommendation letters; and (ii) perform on-site supervision with the frequency based on the assessed project’s risk and performance (first supervision in 9 months after the assessment) and review the project’s financial management and disbursement arrangements to ensure compliance with the WB's minimum requirements. The on-site supervision will include a review of the following areas of project’s financial management: accounting and reporting, internal control procedures and external audits, planning and budgeting, funds flow and staffing arrangements. A sample transactions review will also be conducted. Implementation support and supervision will be performed by the WB-accredited Senior Financial Management Specialist. Other specific activities to be included in the FM supervision plan will include complementing TTL review of claims for reimbursement of eligible expenditures of the EEP components by reviewing quarterly Interim Unaudited Financial Reports

**Figure 2.2.: Flow of Funds (RBF)**



**Procurement**

**25.** Procurement under the proposed project will be carried out in accordance with the WB ‘Guidelines: Procurement of Goods, Works, and Non-Consulting Services under IBRD Loans and IDA Credits & Grants by World Bank Borrowers’, published in January 2011 and revised in July 2014, (Procurement Guidelines) and ‘Guidelines: Selection and Employment of Consultants under IBRD Loans and IDA Credits & Grants by World Bank Borrowers’, published in January 2011 and revised in July 2014, (Consultant Guidelines) and with the latest Guidelines on Preventing and Combating Fraud and Corruption in Projects Financed by IBRD Loans and IDA Credits and Grants.



**26. The capacity of each entity to implement technical assistance activities has been assessed and reflected in Procurement Risk Assessment and Management System.** The team will assess the risks that may negatively affect the ability of the implementing agencies (IAs) to carry out technical assistance selection processes for Part A.5 and B.5 of the project. Each of the IAs will be responsible for the implementation of their respective parts of the project and will report to the WB. Each ministry will also establish PITs, consisting of individual consultants as necessary, that will provide fiduciary support for selection of consultant services and management of consultants contracts.

### *Summary of the Risks and Mitigation Measures*

**27. FBiH and RS.** This is the first project of this type in BiH, and neither of the two ministries has previous experience with RBF, which might result in delays in the implementation process. However, the counterpart and the WB team made sure that the DLI matrix takes into account the reform agenda of the Council of Ministers and the two entity governments and includes realistic indicators and targets in line with capacity constraints and control span of the implementing institutions.

**28.** Currently, it is planned that there will be no procurement of works, it is excepted that only consultants' services can be potentially selected if needed for each entity under relevant allocated technical assistance component of equivalent EUR 0.95 mln for FBiH and EUR 0.95 mln for RS. There could be a need to procure some goods associated with consultants' services which will be defined after TA needs have been identified. This small technical assistance may not be even used if activities will be fully covered as currently planned by other TF sources. In such situation, technical assistance funds would be re-allocated to other categories in the project. Given such project design and the risks identified, the overall risk for procurement is considered as Moderate.

### *Procurement Arrangements*

**29. Procurement of works.** Currently not envisaged.

**30. Procurement of consulting services.** Consulting services under the project may potentially be of various size and complexity. Selection of consulting firms will be done using the World Bank standard Request for Proposal. The employment of technical experts will be conducted through the selection of individual consultants in accordance with the provisions of the Section V of the Consultant Guidelines. In case the service is required from a consultancy firm, the Quality- and Cost-Based Selection method will be applied in accordance with Section II of the World Bank's Consultant Guidelines. Other methods such as Least Cost Selection, Fixed Budget Selection, or Quality Based Selection may also be used. For contracts below USD 300,000 equivalent, the Selection Based on Consultants' Qualification (CQS) method may be used in accordance with paragraph 3.7 of the Consultant Guidelines. The short list can entirely comprise national consultants if the contracts with the firms are below USD 300,000 equivalent. Selection of individual consultants shall follow procedures of section V of Consultant Guidelines.

**31. Procurement of goods and non-consulting services.** Goods may be procured using National Competitive Bidding procedures, procurement will be done using the ECA Region Sample Bidding Documents. Goods and non-consulting services contracts below USD 100,000 may be procured through shopping procedure in accordance with the provisions of paragraph 3.5 of the Procurement Guidelines. Direct Contracting may be used when justified in accordance with provisions 3.7 (a)-(f). Procurement of works is not envisaged under the project.

**32. Procurement under the RBF component.** The major part of the project financing will be disbursed against



eligible expenditures upon meeting DLIs. At this stage, it is not envisaged that there will be any procurement under the RBF component. However, if during project implementation there is a need to procure under this component, this procurement should follow the provisions of paragraph 1.5 of the Procurement Guidelines and paragraph 1.7 of the Consultant Guidelines (as follows):

- **Procurement Guidelines.** “For the procurement of those contracts for goods, works, and non-consulting services not financed in whole or in part from the Bank loan, but included in the project scope of the loan agreement, the Borrower may adopt other rules and procedures. In such cases, the Bank shall be satisfied that the procedures to be used will fulfill the Borrower’s obligations to cause the project to be carried out diligently and efficiently, and that the goods, works, and non-consulting services to be procured: (a) are of satisfactory quality and are compatible with the balance of the project; (b) will be delivered or completed in timely fashion; and (c) are priced so as not to affect adversely the economic and financial viability of the project.”
- **Consultant Guidelines.** “In procuring consulting services not financed in whole or in part from Bank loans but included in the project scope of the loan agreement, the Borrower may adopt other rules and procedures. In such cases, the Bank shall satisfy itself that: (a) the obligations to diligently and efficiently implement the project, and will result in the selection of consultants who have the required qualifications; (b) the selected consultant will carry out the assignment in accordance with the agreed schedule; and (c) the scope of services is consistent with the needs of the project.”

**33. General Procurement Notice.** It will be prepared and submitted to the World Bank after negotiations. The World Bank will arrange for its publication in United Nations Development Business online and on the World Bank’s external website. The General Procurement Notice will contain information concerning the borrower, amount, and purpose of the loan; scope of procurement reflecting the procurement plan; the name, telephone (or fax) number, and address(es) of the borrower’s agencies responsible for procurement; and the address of a widely used electronic portal with free national and international access or website where the subsequent Specific Procurement Notices will be posted.

**34. Procurement Plan.** Each IA will develop an initial procurement plan for the entire project scope consistent with the implementation plan, which will provide information on the technical assistance component and potential selection processes with methods, and the WB review requirements. Since this will cover the entire project completion period, it will be tentative. However, procurement plans for 18 months of the project should be prepared in case the technical assistance component is needed. The procurement plans will be updated in agreement with the WB project team annually or as required to reflect the actual project implementation needs and improvements in the IA’s institutional capacity.

**35. Procurement supervision.** Routine procurement reviews and supervision will be conducted by the procurement specialist in case the technical assistance component is needed. In addition, one supervision visit is expected to take place per year when ex post reviews will be conducted. The WB project team recommends a post review of at least 20 percent of contracts subject to post review. Procurement documents will be kept readily available for the WB’s ex post review during supervision missions or at any other point in time. A post review report will be prepared and shared with the IAs.

**36. Procurement/selection method and prior review thresholds.** Considering the risk assessment rating, it is proposed that the thresholds for procurement activities financed under the project are set in accordance with the latest Europe and Central Asia regional procurement thresholds. The thresholds will be specified in the procurement

plan.

**Table 2.1. Potential procurement packages for technical assistance component**

Description	Type	Cost Estimate (EUR)	Selection Method	Review	Planned Date (Tender Launch)	IA
Consultants services – multiple packages (to be determined) (TBD)	CS	600,000	CQS (or QCBS, QBS,FBS,LCS) TBD	Post	July 2018	FBiH
Other goods packages - multiple packages (TBD)	Goods	230,000	NCB/Shopping	Post	July 2018	FBiH
Selection of individual consultants (PIT) – multiple packages TBD	CS	120,000	IC	Post	July 2018	FBiH
<b>Subtotal FBiH</b>	<b>CS</b>	<b>950,000</b>	<b>Multiple packages</b>			
Consultants services – TBD once needed	CS	600,000	CQS (or QCBS, QBS,FBS,LCS) TBD	Post	July 2018	RS
Other goods packages - multiple packages (TBD)	Goods	230,000	NCB/Shopping	Post	July 2018	RS
Selection of individual consultants (PIT) – multiple packages TBD	CS	120,000	IC	Post	July 2018	RS
<b>Subtotal RS</b>	<b>CS</b>	<b>950,000</b>	<b>Multiple packages</b>			

Note: CS = consultants services; IC=Individual Consultant; NCB = National Competitive Bidding; CQS= Consultants Qualifications Selection; QCBS= Quality and Cost-based Selection; QBS=Quality Based Selection; FBS= Fixed Budget Selection; LCS=Least-Cost Selection.

### Social (including Safeguards)

**37. The project does not expect to have negative social effects.** The proposed components aim to improve the enabling environment for households and enterprises to get access to finance by mainly focusing on improving institutional, regulatory and supervisory frameworks for the banking sector. It is unlikely and unforeseeable that any particular social groups will be negatively affected.

**38. Citizen Engagement.** Public consultations on drafting legislation are required by law in BiH. Regulation on Consultations in Legislative Drafting (published in the “Official Gazette of BiH”, no 81/06 and 80/14) guides procedures for consultations with general public and organizations that are mandatory for all ministries and other institutions when drafting any legislative acts. The banking agencies make all draft bylaws available on their websites. The project will work with the Agencies to ensure that a log is kept of the number of comments or suggestions to draft bylaws received, and how these have been incorporated. In addition, the CBBH publishes financial data and other relevant information about the banking sector on a regular basis to inform and facilitate feedback from the



general public. Jointly with USAID, the CBBH launched on its website the Educational Component to promote financial literacy and thus increase public awareness and participation in the consultations on legislative changes.

**39. Gender:** There are no gender inequalities in areas of direct relevance to the project because the project deals with the banking regulatory and supervisory framework and not end users. The project has therefore limited direct impact on end users of the banking system, which is where some gender disparities are still found. Nevertheless, reforms to strengthen and further develop the financial system may indirectly contribute to including underrepresented groups, such as women, in the financial sector. Limited available data suggests that females are less included in the financial system than men in BiH with a lower share having an account or savings in a financial institution.<sup>25</sup>

**40. Social Safeguards:** Operational Policy 4.12 on Involuntary Resettlement will not be triggered as the project does not include civil works and land acquisition will not occur.

**Environment (including Safeguards)**

**41. The project does not trigger any WB environmental safeguards policies.** Therefore, the project has been assigned a Category ‘C’ in accordance with the WB safeguard policy OP/BP/GP 4.01.

**Monitoring and Evaluation**

**42. The main outcome indicators for the project and intermediate results indicators (listed in section VII) and DLIs (listed in Annex 1), will serve as the basis for results monitoring and evaluation.** The PITs will be responsible for collecting the data required for monitoring and evaluation and for verification of the DLIs under their responsibility based on protocols outlined in this Annex. Indicators will be measured against agreed results and compared to defined baselines. Project progress reports will be prepared by the entity MoFs on a semi-annual basis. PITs will also be responsible for updating the procurement plan in line with technical assistance activities.

**Table 2.2: Verification Protocols for Disbursement Linked Results<sup>26</sup>**

DLI	Summary of Verification Protocol
DLR 1.1: BAs have (i) completed a quantitative impact study on draft regulations on liquidity and capital; and (ii) published the results on their websites.	Official letters from MoFT confirming that the quantitative impact study on liquidity and capital regulations has been completed and results been published on the respective BAs website, with a copy of the respective QIS report attached.

<sup>25</sup> In more detail, women lag behind men when it comes to financial inclusion in certain aspects. According to the Bank’s global FINDEX database, in 2014, an estimated 59 percent of men in BiH had access to a bank account compared to 47 percent of women. Women also lag behind men with regard to access to savings accounts, with only 6 percent of women reporting savings within the last year compared to 12 percent of men. Borrowing from financial institutions has been growing, with no significant gender gaps in borrowing patterns. In fact, in 2014, women were ahead when it comes to borrowing at a formal financial institution with about 16 percent compared to 12 percent of men.

<sup>26</sup> The ex-ante verification of achievement of individual DLRs will be conducted by the WB team based on the evidence listed in this table. Verification of DLRs 1.1-3.3 applies to both sets of DLRs (Federation and RS) equally but are not interlinked with one another. The verification table will be included in the POMs and can be modified during project implementation.



<p>DLR 1.2: Bylaws on (i) capital; (ii) liquidity; (iii) risk management standards, including risk appetite framework and internal governance; (iv) internal capital adequacy assessment process (ICAAP), and (v) consolidated supervision adopted</p>	<p>Official letters from MoFT confirming that bylaws on i) capital; (ii) liquidity; (iii) risk management standards, including risk appetite framework and internal governance; (iv) internal capital adequacy assessment process (ICAAP), and (v) consolidated supervision have been adopted by FBA/BARS respectively, with a copy of the respective regulations attached.</p>
<p>DLR 1.3: Adoption of new risk based SREP methodology aligned with EU (EBA) standards</p>	<p>Official letters from MoFT confirming that a new risk based SREP methodology has been adopted by FBA/BARS respectively, with a copy of the respective methodology report attached.</p>
<p><i>Definitions, evidence, and verification protocol:</i></p> <p>Definitions:</p> <ul style="list-style-type: none"> <li>• Quantitative impact study (QIS) is undertaken to collect data on the newly proposed by-laws on capital requirements on credit risk, market risk, and operational risk, and on liquidity coverage ratio.</li> <li>• SREP is a supervisory review and evaluation process aimed at enhancing transparency and harmonization of supervisory review processes in the EU.</li> <li>• Bylaws are regulations prepared by the BAs and adopted by their respective Supervisory Boards and published in the Official Gazette.</li> <li>• BAs refer to Banking Agency of Federation BiH and Republika Srpska respectively.</li> </ul> <p>Means of Verification:</p> <ul style="list-style-type: none"> <li>• The bylaws will be reflected in: i) the internal guidelines / decrees to be adopted by the banking agencies, and ii) published in the Official Gazette.</li> <li>• If the DLRs have not been met in full: <ul style="list-style-type: none"> <li>• Partial achievement of DLR 1.1 and 1.2 may result in a partial disbursement as set forth in the Loan Agreement.</li> </ul> </li> </ul> <p>Procedures:</p> <ul style="list-style-type: none"> <li>• FBiH/RS PITs collect and compile information through direct communication with the BAs, the website of banking agencies and respective official gazettes.</li> <li>• FBiH/RS PITs collect and prepare for the entity MoFs quarterly interim unaudited financial reports (IFRs) on eligible expenditures to be sent to the WB.</li> <li>• FBiH/RS MoFs send the evidence of achievement of DLIs when they have been achieved to WB TTL for verification, via Ministry of Finance and Treasury BiH.</li> </ul>	
<p>DLR 2.1: Banking Agencies (i) adopted a harmonized 2017 AQR framework; (ii) approved the final reports of AQRs of all banks in BiH’s territory not previously subject to an AQR based on the harmonized 2017 AQR framework.</p>	<p>Official letter from MoFT confirming that (i) harmonized 2017 AQR framework was adopted by the respective Banking Agency and (ii) AQRs undertaken in 2017 for all respective banks not previously subject to an AQR based on harmonized 2017 AQR framework developed with support of the WB have been completed and approved by FBA/BARS respectively.</p>
<p>DLR 2.2 and DLR 2.3: All undercapitalized banks have in place either mandatory time bound corrective action programs or resolution/liquidation programs</p>	<p>Official letter from MoFT confirming that all undercapitalized banks stemming from the 2017 AQR have in place either mandatory time bound corrective action programs or resolution/liquidation programs approved by FBA/BARS respectively.</p>
<p><i>Definitions, evidence, and verification protocol:</i></p>	



<p><b>Definitions:</b></p> <ul style="list-style-type: none"> <li>Asset Quality Review for 2017 will include 12 banks (8 in FBiH and 4 in RS).</li> <li>BAs refer to Banking Agency of Federation BiH and Republika Srpska respectively.</li> </ul> <p><b>Means of Verification:</b></p> <ul style="list-style-type: none"> <li>BAs statement of having issued orders of either mandatory time bound corrective action programs or resolution/liquidation programs for all undercapitalized banks.</li> <li>Partial achievement of DLR 2.1 may result in a partial disbursement as set forth in the Loan Agreement.</li> <li>If the DLRs 2.2 and 2.3 have not been met in full any given year: <ul style="list-style-type: none"> <li>Disbursements withheld due to non-achievement of DLRs in a given year may be released in subsequent years once the DLR is achieved, or cancelled by the Bank.</li> </ul> </li> </ul> <p><b>Procedures:</b></p> <ul style="list-style-type: none"> <li>FBiH/RS PITs collect and compile information through direct communication with the BAs, the website of banking agencies and respective official gazettes.</li> <li>FBiH/RS PITs collect and prepare for the entity MoFs quarterly interim unaudited financial reports (IFRs) on eligible expenditures to be sent to the WB.</li> <li>FBiH/RS MoFs send the evidence of achievement of DLIs when they have been achieved to WB TTL for verification, via Ministry of Finance and Treasury BiH.</li> </ul>	
DLR 3.1: Bylaw on recovery plans adopted aligned with EU (EBA) standards.	Official letter from MoFT confirming the adoption of a bylaw on recovery plans by FBA/BARS respectively, with a copy of the respective regulation attached.
DLR 3.2: Resolution unit established and made operational	Official letter from MoFT confirming that FBA/BARS respectively have established and made operational resolution units which are adequately resourced and staffed as well as organizationally and functionally independent from supervision.
DLR 3.3: Number of recovery plans submitted and assessed in line with internal assessment methodology	Official letter from the MOFT confirming that FBA/BARS have received and assessed recovery plans submitted by all banks licensed in their respective territory in line with newly developed internal assessment methodology.
<p><i>Definitions, evidence, and verification protocol:</i></p> <p><b>Definitions:</b></p> <ul style="list-style-type: none"> <li>Bylaws are regulations prepared by the BAs and adopted by their respective Supervisory Boards and published in the Official Gazette.</li> <li>BAs refer to Banking Agency of Federation BiH and Republika Srpska respectively.</li> </ul> <p><b>Means of Verification:</b></p> <ul style="list-style-type: none"> <li>The bylaw will be reflected in: i) the internal guidelines / decrees to be adopted by the banking agencies, and ii) published in the Official Gazette.</li> <li>Recovery units: new units to be established within each BA following adoption of new Banking Law(s). New organogram and statute of each BA to reflect this.</li> <li>BAs confirmation that all banks submitted recovery plans and that BAs have assessed them.</li> </ul> <p><b>Procedures:</b></p> <ul style="list-style-type: none"> <li>FBiH/RS PITs collect and compile information through direct communication with the BAs, the website of banking agencies and respective official gazettes.</li> </ul>	



<ul style="list-style-type: none"> <li>FBiH/RS PITs collect and prepare for the entity MoFs quarterly interim unaudited financial reports (IFRs) on eligible expenditures to be sent to the WB.</li> <li>FBiH/RS MoFs send the evidence of achievement of DLIs when they have been achieved to WB TTL for verification, via Ministry of Finance and Treasury BiH</li> </ul>	
DLR 4.1: FBiH and RS governments to approve a strategic statement for RFBiH and IRBRS' future development	Official letter from the MoFT confirming that FBiH and RS Governments have each adopted and gazzetted a strategic statement for future development of RFBiH and IRBRS requiring that: the banks will comply with the respective Banking Law and will be supervised by the BAs under a regulatory scheme adapted to the banks' funding model; will operate on a financially sustainable basis; the structure of governance and risk management of the banks will conform to the regulations of the BAs; and the RFBiH will operate predominantly as a wholesale institution - with the exception of participation in syndicated credits involving at least two other domestic or foreign banks or IFIs (as regards to credit and guarantee agreements entered into by the bank after 1 January 2018) - while IRBRS will operate as a wholesale institution only.
DLR 4.2a: RFBiH's business plan for 2018-20 approved by the Shareholders Assembly	Official letter from the MoFT confirming that the Shareholders Assembly of RFBiH has approved the bank's business plan for 2018-2020 in line with the FBiH Governments strategic statement, with a copy of the respective business plan attached.
DLR 4.2.b Transfer of identified Funds' assets aligned with IRBRS' strategy to IRBRS in compliance with (i) amended IRBRS Law specifying IRBRS' revised mandate, and (ii) IRBRS regulations and BARS bylaw governing the application of banking regulations to IRBRS.	Official letter from the MoFT confirming that ownership of eligible assets has been transferred from the Funds to IRBRS and attaching a copy of the BARS bylaw governing the application of banking regulations to IRBRS published in the Official Gazette.
DLR 4.3a: RFBiH's risk management strengthened	Official letter from the MoFT confirming that RFBiH has adopted measures to fully align its risk management organization, reporting lines, and risk management policies and procedures with FBA regulations.
DLR 4.3.b: IRBRS is in full compliance BARS bylaw governing the application of banking regulations to IRBRS	Official letter from the MoFT confirming that IRBRS adopted measures to fully comply with BARS bylaw governing the application of banking regulations to IRBRS.
<p><i>Definitions, evidence, and verification protocol:</i></p> <p>Definitions:</p> <ul style="list-style-type: none"> <li>Strategic statement: a statement on the strategic direction of RFBiH and IRBRS respectively; approved by the respective entity government.</li> <li>Business Plans (each) are designed to implement the strategy. They will be developed by management and approved by the supervisory board and shareholders' assembly. The business plan should provide financial projections and pricing policies for financial products offered by the bank that allow the bank to be sustainable.</li> </ul> <p>Means of Verification:</p> <ul style="list-style-type: none"> <li>RFBiH and IRBRS make available to respective MoFs bylaws, internal policies, procedures and organisational changes; these will include submission of Supervisory Board's meeting minutes.</li> <li>RFBiH and IRBRS make available to respective MoF's copies of the strategic statements, business plans and annual audited financial statements for the bank along with a schedule disclosing the proportions of syndicated</li> </ul>	



and wholesale credit in the post-1 January 2018 credit portfolio, and copies of loan documents for any syndicated credits in which the bank participates.

Procedures:

- FBiH/RS PITs collect and compile information from the respective development bank.
- FBiH/RS PITs collect and prepare for the entity MoFs quarterly interim unaudited financial reports (IFRs) on eligible expenditures to be sent to the WB.
- FBiH/RS MoFs send evidence of DLIs achievement to WB TTL for verification that they have been achieved, via Ministry of Finance and Treasury BiH



## ANNEX 3: IMPLEMENTATION SUPPORT PLAN

COUNTRY: Bosnia and Herzegovina  
Banking Sector Strengthening Project

### Strategy and Approach for Implementation Support

1. **The Implementation Support strategy was developed taking into account the risks and their mitigation measures related to the operation and aims to ensure the provision of efficient implementation support to the client.** These project risks include: (i) the policy risk, which is the ability and willingness of authorities to pursue the identified reform of banking system and financial safety net; and (ii) the operational risk, which is related to the fragmentation of the institutional framework and lack of coordination between key stakeholders in BiH.
2. **The Implementation Support strategy relies on project design features, and policy dialogue and technical assistance along with key development partners as enabling tools for risk mitigation.** The strategy for mitigating the above-mentioned risks includes the following measures:
  - a. *Policy risk:* There is a universal agreement with key development partners (EU, IMF, EBRD, KfW, USAID) on the importance of the reforms tackled by this operation, which has been central to recent policy discussions with the authorities. The adoption of a three-year IMF EFF program in 2016 provides an anchor for the medium-term macro-fiscal framework and, in conjunction with related WB operations including the Public Finance DPL and this operation, help to mitigate these risks. The WB will remain actively engaged in implementing the ambitious banking sector reform agenda initiated by this operation through policy dialogue and technical assistance, in particular via the Vienna Financial Sector Advisory Center and the UK Good Governance Trust Fund.
  - b. *Operational risk:* The team plans to tackle the fragmentation of the institutional framework through a clear division of responsibilities and up-front agreement on the deliverables. The establishment of dedicated technical teams at the Entity MoFs and focal points at each banking agency and the entity development banks is expected to mitigate a risk of any potential delays in project implementation that might be caused by the limited capacity and experience of the key stakeholder in implementing IBRD operations.

### Implementation Support Plan and Resource Requirements

3. **The WB team will support project implementation using its own staff.** The Bank team supporting the implementation of the operation will include staff based in Washington DC, Bosnia and Herzegovina, and FinSAC (Vienna office). The details on a number of staff weeks and skills requirements are provided in the table below.



Time	Focus	Skills Needed	Resource Estimate	Partner Role
First twelve months	Team Leadership	Project management (HQ and Sarajevo based staff)	10 Staff Weeks (SW)	
	Financial Management	FM Specialist (Sarajevo)	2 SW	
	Technical expertise	Sr. Financial Sector Specialists (HQ)	3 SW	
	Technical expertise	Sr. Financial Sector Specialists (Vienna)	2 SW	
	Operational support	Program Assistant (Sarajevo)	4 SW	
Year 2-3	Team Leadership	Project management (HQ and Sarajevo based staff)	8 SW per year	
	Financial Management	FM Specialist (Sarajevo based)	2 SW per year	
	Technical expertise	Sr. Financial Sector Specialists (HQ)	3 SW per year	
	Technical expertise	Sr. Financial Sector Specialists (Vienna based)	2 SW per year	
	Operational support	Program Assistant	4 SW per year	