Convertible loan to a bank in an early transition country
Summary of the Operation Performance Evaluation Review
February 2006

THE PROJECT
In 1998, the Board approved a convertible loan to the client of US$ 7 million. The Bank had an option to convert part of the outstanding loan into equity. The Bank exercised its right to convert in June 2000, acquiring an 18 per cent equity stake which was diluted to less than 16 per cent when a second IFI became a shareholder in 2001. Subsequent transactions have diluted the Bank's holding further to approximately 12 per cent. In 2003, the EBRD's Board approved a US$ 4 million senior loan to the client. In 2005, the Board approved participation of up to US$ 1 million in a capital increase.

PROJECT RATIONALE
Each of the EBRD's operations with the client to date has been designed to support its growth as an institution and development of the banking sector, and also to achieve outreach to small and medium-sized privately owned businesses (SMEs). The conversion of part of the loan to equity in 2000 enabled the Bank to participate more actively in governance through representation on the client's supervisory board. The operations to date have had a clear rationale with regard both to their institution-building goals and to their broader transition objectives.

ACHIEVEMENT OF OBJECTIVES
The Bank's several operations with the client have focused on five key objectives. These have been to improve corporate governance in the second largest bank in the country (**achieved**) and, in so doing, to strengthen the institution leading to increased competition in the sector (**achieved**); to enhance provision of retail banking services by the client (**achieved**); to provide medium-term resources for on-lending to SMEs (**achieved**); and to assist management to bring the client up to international operating standards (**substantially achieved**).

OVERALL ASSESSMENT
The Evaluation Team assigns an overall rating of *Successful* to the EBRD's relationship with the client as reflected in the achievements of the operations under review. With the assistance of credit advisors, the client built up good quality SME sub-loan portfolios and began to assimilate sound credit appraisal and monitoring practices. The EBRD was instrumental in organising key shareholders as a cohesive group in order to effect management changes. A new management team instigated a thorough review of operations and made necessary changes to procedures. *Excellent* transition impact has been achieved in the areas of competition and market expansion. The demonstration effect is also rated *Excellent* since the client has become known as the most innovative bank in the country introducing new products, services, systems and controls that other banks are seeking to copy.

TRANSITION IMPACT AND THE BANK'S ADDITIONALITY
The overall impact of the Bank's various operations with the client has been substantial. TC assignments that accompanied EBRD operations have made a strong contribution to the client's institutional development which has been magnified by EBRD's governance role on the supervisory board. The Evaluation Team considers that the overall impact of the EBRD's relationship with the client warrants a rating of *Good*. At appraisal of the first transaction, the transition impact of the project was expected to be significant, in supporting competition and improving confidence in the banking sector. The 2003 SME loan was rated ex-ante to have *Good* TI potential with *High* risk. After significant developments on the political front and at the client bank, the OPER team is of the view that the relationship now has *Excellent* transition impact and that the *High* risk factors identified previously have been mitigated somewhat. The risks may

now be assessed as *Medium* with a focus that has shifted from the macro-economic environment to the client's capacity to manage its ambitious growth strategy. Environmental performance is assessed as *Satisfactory* and extent of environmental change *Some*. The EBRD's equity and debt operations have clearly been additional both in financial terms and as regards the contribution to governance exercised through representation on the supervisory board. The additionality of the operations under review is *Verified in all respects*.

BANK HANDLING

Bank Handling is rated *Excellent* to reflect the positive influence on the client and the sector of operations, and the EBRD's contribution to improvements in governance which were facilitated by good project design and implementation.

MAIN OPER ISSUES AND LESSONS LEARNED

The timing of equity exits should be guided principally by transition impact potential. It is likely in the present case that the client could function profitably, and perhaps maximise short-term financial returns, without continued Bank involvement as a shareholder. However, there remains significant transition impact potential in the relationship. Focusing on the transition goals of market expansion, increased competition, sound governance and demonstration effect may produce higher financial yields in the long term to the benefit of all stakeholders.

Special purpose credit lines in early transition countries help promote the expansion of SME lending and stimulate competition. The credit lines must be accompanied by appropriate institution-building and skills transfer measures. Loan covenants should be tailored to the requirements of partner banks on a case-by-case basis to reflect the needs of the partner bank in the country context.

Acceptance by the EBRD of a dilution of its shareholding may be appropriate when it serves to advance the achievement of transition objectives. In the present case, EBRD's acceptance of the dilution which resulted from the issue of new shares has helped advance the transition process. The new share issue facilitated consolidation in the sector and the introduction of portfolio investors.