Summary of the Operation Performance Evaluation Review (February 2007)

THE EQUITY INVESTMENT AND OTHER EBRD OPERATIONS WITH THE CLIENT

In September 2004 the EBRD's Board approved an equity investment of approximately US$ 10 million to acquire a stake representing 25 per cent plus one share of the capital and voting rights of a regional bank (the client) through a subscription to new shares. After the EBRD investment, the majority shareholder group retained over 60 per cent of the client bank. In October 2005 the Board approved the Bank's participation in a capital increase which involved the investment of approximately US$ 5 million equivalent in new ordinary voting shares and US$ 10 million in convertible preference shares. The total new issue of voting shares amounted to US$ 20 million with US$ 10 million being acquired by a large European development finance institution and US$ 5 million by a western asset manager. In June 2006 the Board approved further exposure of US$ 20 million. Together with the EBRD portion (A loan), a B loan of US$ 40 million was syndicated to commercial banks. In addition to the above facilities, the EBRD signed a US$ 5 million mortgage loan with the client in November 2006. The EBRD gave its approval for the merger of the client bank with another bank which was completed successfully.

PROJECT RATIONALE

The client began lending under an EBRD small business lending programme in 2003 giving the Bank the opportunity to get to know the client's management and principal shareholders. This experience and subsequent discussions and negotiations persuaded the EBRD that the client would benefit from the Bank's participation as a shareholder. The client bank's management and shareholders demonstrated willingness to restructure in accordance with good banking practice and to observe sound governance standards. The OPER team considers that there was a sound rationale underlying the Bank's equity investment and the accompanying institution-building programme. Among other benefits, the EBRD equity investment facilitated the client's efforts to gear up on the capital injection through commercial borrowings, enabling rapid growth of the loan book.

ACHIEVEMENT OF OBJECTIVES

The August 2004 Board document proposing the equity investment aligned the project objectives with transition impact goals, observing that significant transition impact was anticipated in the following areas:

- Enhancing the ability of regional banks to compete with nationwide banks, improving financial intermediation. *(Achieved)*
- Setting standards for corporate governance and business practices. *(Achieved)*
- Securing demonstration effect by supporting the growth of a private bank with high standards of corporate governance and business conduct. *(Achieved)*

OVERALL ASSESSMENT

Based on its independent assessment, the OPER team assigns an overall assessment rating of *Highly Successful* to the Bank's equity investment. An appropriate level of technical assistance accompanied the EBRD's equity investment to facilitate the wide-ranging institution-building plan. Through supporting the merger of the client with another commercial bank, the Bank has also supported the consolidation of two important regional banks. This sends a strong signal to the market at a time when banking sector consolidation is constrained by complex and time-consuming regulatory requirements and by reluctance on the part of some shareholders in regional banks to contemplate shared ownership. Overall transition impact is rated *Excellent* based on the achievements observed in the following areas: the expansion of a competitive financial market in the region; the institutional strengthening of the client through improved governance, management, operations and systems; and the promotion of appropriate market behaviour in an increasingly competitive environment. The remaining transition impact potential is also rated *Excellent*, chiefly in view of the synergies and further growth that can be expected to result from the merger. The risk to achieving the remaining potential is rated *Low* in view of the commitment of the main shareholder group to the merger and their earlier experience in merging regional banks successfully. Additionality is *Verified in All Respects*. In financial terms the Bank's involvement facilitated access to the international capital markets by the client while in institutional terms the design and structure of the operation resulted in significant improvements in the client's management, operations and systems.

BANK HANDLING

The OPER team considers the EBRD has been instrumental in stimulating the positive changes at the client bank and assigns a rating of *Excellent*[1] to bank handling to reflect the efforts made to minimise the risks for the Bank as a shareholder while seeking to encourage the merger of two regional banks and the strong transition impact that is likely to result.

MAIN OPER ISSUES AND LESSONS LEARNED

Capturing information about significant changes in business interests where the Bank client is a key business of an entrepreneur. Prominent shareholders or senior managers of companies in which the Bank has invested may take opportunities to invest personal funds in ventures that, as a consequence, become related to the client company. Even in the absence of business transactions between such entities, there is potential for increased credit and reputational risks to the Bank arising from new related party connections. To enable the Bank to assess the possible impact of such risks, operation teams should seek to obtain details of material changes in the business interests of persons in positions of influence in a Bank client to be reported to the Bank's Credit department annually or semi-annually as part of the regular monitoring process.

By encouraging clients to expand the range of investment instruments offered to the market, the Bank can help stimulate outside investor interest and reduce potential exit risk for the Bank. In this case the client used the relatively innovative instrument of perpetual preference shares which were successfully placed with a number of portfolio investors. While the issue did not fully satisfy outside investor interest, it served to boost investor confidence in the client and in so doing demonstrated the presence in the market of potentially suitable purchasers of the shares held by EBRD at the appropriate time.

A carefully designed institution-building plan can enhance investment returns for the Bank as well as promoting transition goals. In this case, the client's undertaking to implement the agreed institution-building plan was secured in key agreements between the Bank and the client. Successful implementation of the plan has contributed significantly to the client's commercial success and increase in value in addition to the achievement of transition goals at corporate and industry level.

Identifying success factors to underpin effective development of financial institutions. This case illustrates a number of factors whose presence may promote the successful outcome of Bank investments in financial institutions. Among them are:

- Willingness of owners to appoint professional managers and to separate ownership from management.
- Acceptance of strict limits to related-party transactions which in any event must be conducted on an arm's-length commercial basis.

[1] Ratings: Excellent, Good, Satisfactory, Marginal, Unsatisfactory, Highly Unsatisfactory.

- Willingness to accept IFIs as shareholders with a blocking minority stake.

The importance of consolidation in selected sectors. In sectors, such as the financial sector, where consolidation is desirable, but is constrained by underdeveloped market conditions or complex regulatory requirements, the Bank may be in a strong position to support the process of consolidation. In transition economies, private owners are frequently reluctant to consider sharing ownership and control even when the economic case for merger is strong. In this case, the Bank pursued the opportunity to stimulate enterprise consolidation with an excellent outcome, thereby enhancing economic value and promoting financial sector transition.