Loans to a real estate project in the former Soviet Union

THE PROJECT

In October 2003, EBRD approved loans to the owners of two adjacent office buildings in a country of the former Soviet Union. The project also provided for a legal transition technical cooperation (TC). The purpose of the loans was to reorganize the financial structure of the ownership of the buildings, finance completion of and improvements to one of the buildings, provide working capital, and achieve several transition objectives. The latter included finding a solution to the legal deadlock preventing perfection of mortgages, with specific reference to allowing appropriate security to be taken over the project buildings. EBRD entered into dialog with the government of the country to improve the legal frameworks for property markets, including the infrastructure for registration of mortgages over real estate. EBRD planned to implement a Legal Transition TC programme, for the benefit of the government, to support the property sector reforms. Specifically, the EBRD sought to aid the government to establish a mortgage registry that would allow lenders to publicise a mortgage over real estate. It would ensure legality, publicity and priority of mortgages over real property, none of which existed at the time of project approval, or today, in the country. The TC project was cancelled in October 2005 after an expenditure of about 10 per cent of the approved amount.

PROJECT RATIONALE

The project would comply with the Bank’s 2002 strategy for the country of operations and directly implement the 2001 Property Operations Policy especially in the field of market supporting institutions and frameworks for markets, in part by supporting diversification into early/intermediate transition countries.

ACHIEVEMENT OF OBJECTIVES

The project had *marginal* achievement of objectives because it only partly achieved its borrower-level, corporate governance objectives; did not achieve adequately perfected first ranking mortgages on the project properties or the intended demonstration effects of doing so; and did not achieve the objectives for improving Frameworks for Markets.

OVERALL ASSESSMENT

The project is rated overall as *partly successful.* The project did not achieve adequately perfected mortgages and, therefore, did not create the intended demonstration effects. The planned TC, whose preparation led to deep and valuable insight into the institutional deficiencies in the country and the need for property sector reform, was cancelled and did not fulfil its objectives. Achievement of objectives was *satisfactory*: some of the borrower-level objectives were achieved, but not achieved beyond the firm in the form of demonstration effects of implementing an adequately perfected mortgage, or through reform of the system for registering mortgages. Transition impact is rated as *marginal*: some impact at the level of the company’s corporate governance did not offset poorer performance at the level of the sector and the economy as a whole. Transition in the property sector and the economy as a whole is poor to negative; the lack of transition blocked both the creation of demonstration effects at the level of the firm and their transmission beyond the firm. Bank handling is rated *satisfactory*, tending toward marginal. Additionality is rated as *verified in all respects*. The financial performance of the project and the company and the investment performance for the Bank are all rated as *good*. The degree of environmental change is rated as *none* and the environmental performance of the project and the Sponsor as *satisfactory* in a context of limited environmental risk.

BANK HANDLING

Bank handling is rated as *Satisfactory* tending toward marginal. The mortgages were not adequately perfected, because of defects in the legal and institutional framework, and the Bank has not taken any actions to pursue further perfection of the mortgages.

MAIN OPER ISSUES AND LESSONS LEARNED

The role of legal advice regarding loan security arrangements. Bankers must be able to rely on their legal advisers for clear, unambiguous advice about the adequacy of security documentation and the perfection and enforceability of security interests. The role of the legal adviser is to make clear any drawbacks that the documentation, the laws or the institutional frameworks may cause, and make clear the resulting risks so that bankers can determine whether such risks should be assumed by the EBRD or not. If the legal advice does not make the legal and security risks clear to the banker, the banker will be unable to make appropriate decisions. Where the best efforts of legal structuring have not succeeded in removing certain drawbacks to the security arrangements, the legal advice must make that fact and the resulting risks clear, and bankers must record and monitor the deficiencies of the structure. The existence of drawbacks in the legal frameworks should not be allowed to lower the rigour of the legal advice regarding the risks that have been incurred.

TC projects that pursue institutional change in corrupt environments need support from the highest country authority. It may be appropriate to enter into a memorandum of understanding with the president of the country, perhaps after approval by the president's cabinet, to reduce the risk that ministers will attempt institutional reforms that are later abandoned for lack of backing by the president.

TC projects that pursue institutional reforms in the property sector in corrupt environments need support and parallel programmatic assistance from the World Bank and other donors. Involvement and support of the World Bank and other leading donors can aid in the design and implementation of institutional reform projects in the property sector. Such involvement, when evidenced in the reform programme agreed between the World Bank and the country, may reduce the risk that such property sector reforms will fail technically and politically.

Recommendation. The Bank should consider taking steps, including potentially legal transition TC, to understand the country's legal framework for registering a security interest over leased land to take bring about a registration of a security interest in the project's land leases or the related rights. This would be a discrete task that could be less complex, and perhaps less controversial, than setting up an independent mortgage registry in the country. The benefits of achieving the registration would be to complete a missing element of the Bank's security for the project, and to provide a mechanism for other borrowers to pledge the right to use leased land as security. It would, moreover, be consistent with the Bank's commitment to address legal framework reform consistent with the property sector policy.

Article 1 and 2 undertakings on market economy and sectoral reform in the property sector. In some EBRD countries, inadequate, conflicting and mutually undermining laws and regulations about registration of real property and mortgages block transition to a market economy in the property sector. They also block the EBRD and other banks from being able to perfect mortgages on real property for the purposes of financing SMEs as well as property sector projects. The poor frameworks for markets would appear to constitute, therefore, policies that are inconsistent with the economic dimensions of Article 1 and should be treated as such in the future in the EBRD's assessment of a country's adherence to the economic dimensions of Article 1.

Recommendation. Given that Article 8 of the Agreement Founding the EBRD permits formal suspension or modification of access to Bank resources in the face of policies inconsistent with Article 1, it would be appropriate in the future for the Bank to consider more closely the degree of the country's compliance with the economic dimensions of Article 1 as articulated, also, in terms of Article 2 sector reforms.

Recommendation. The Bank should consider adopting a more structured approach to policy dialogue with the country's authorities regarding legal and institutional reforms in the property sector and more broadly. The Bank should consider focusing on the remaining transition challenges in market supporting institutions and policies, especially fostering privatisation and private management of public sector-controlled real estate and radical reform of the legal and institutional frameworks for property markets. The core of the policy dialogue could address the authorities' commitment to bring about transition to a market economy in the property sector and the removal of policies that are inconsistent with the economic dimensions of Article 1. A first step could be for the Bank and the country authority to issue a joint statement about the state of transition in the property sector in order to avoid a "dialogue of the deaf". Further commitment to sector reform could be signalled by the setting of milestones, ratified at the highest level of the country authority, for implementing the needed reforms in the sector.