Summary of the Operation Performance Evaluation Review (November 2005)

THE PROJECT

The project, approved by the EBRD's Board of Directors in late 2002, aimed to expand residential housing loan business in the country. EBRD committed a €15 million loan for 12 years that was signed in 2003 and fully disbursed within six months. One half of the proceeds of the project loan were to be applied to extend the maturity of part of the client's existing portfolio of housing loans and the other half for the granting of new loans for acquiring or refurbishing residential property. All in all, the Bank has so far signed four 12-year mortgage finance facilities with local banks for a total of €206 million. Hence, the OPER report considers the project in the context of this series of mortgage finance facility projects in the country.

PROJECT RATIONALE

The operation report described the rationale for EBRD involvement in the project:

- Facilitate provision of long-term funding of individuals for purchasing of principle residences in the country.
- Meet the growing demand for mortgage finance and support the development of mortgage activity through both banks and specialised mortgage institutions.
- Support the client to become a major player in retail banking and encourage stronger competition.
- Respond to market demand from banks for maturity extension facilities for mortgages.

OVERALL ASSESSMENT

The project is rated *Successful* overall. Transition impact was *Good*, both verified and for remaining potential. Transition risk is *High*, mainly because devaluation would harm borrowers and lenders of housing loans and other loans indexed to foreign currencies, putting systemic stress on local banks with the risk of negative impacts on the EBRD's large exposure to the country's banking system. The poor trends in external balance, as assessed by the IMF, point to a rising risk of devaluation in the country. Achievement of objectives is rated as *Good*. Additionality is *Verified in All Respects* thanks to the 12-year loan tenor; banks in the West rarely lend money for more than five years to any commercial bank. Environmental performance is rated as *Satisfactory* and environmental change as *None*. The company's financial performance is rated as *Satisfactory* and project financial performance is rated as *Good* because the portfolio of 386 housing sub-loans has evidenced low arrears to date. The Bank's investment performance is judged to be *Satisfactory*. Bank handling is rated as *Satisfactory*.

ACHIEVEMENT OF OBJECTIVES

The *objectives* of the mortgage loan project were to:

- Facilitate provision of long-term financing to individuals for purchasing or renovating residences. (Achieved)
- Standardise the mortgage loan documentation for possible future securitisation. (Achieved)
- Allow the client to expand its mortgage finance operations and diversify its funding base. (Achieved)
- Allow maturity extension of the current portfolio. (Achieved)

BANK HANDLING

Bank handling is rated as *Satisfactory* mainly because stimulating growth of the housing loan market was not matched by Bank effectiveness in obtaining improvements to the institutional frameworks for mortgages that the country strategy papers had identified were needed in the country. Also, the Bank had repeatedly identified but did not monitor, at the borrower level, the systemic risk to local banks, and to its own large exposure to the national banking system, posed by widespread use of loans indexed to foreign currency (see recommendation on currency risk below).

MAIN OPER ISSUES AND LESSONS LEARNED

Taking a proactive approach rather than waiting for mortgage reforms. Stimulating the growth of housing loans can spur demand by consumers and banks for reform of the institutional frameworks for property and mortgages that the Bank could address through complementary projects. Consumers, SMEs and banks that seek to implement mortgage loans have incentives to demand improvements to a country's capacity to register real estate and mortgages. The Bank should consider complementing its mortgage finance facilities in a given country by undertaking projects, consistent with the Bank's property sector policies, to remedy the shortcomings in the mortgage institutional frameworks early in its engagement in a country. This lesson is especially relevant for the Bank's work in the fourteen countries in the south and east of the region that have, according to the EBRD's 2005 Assessment of Transition Challenges report, "Large" remaining transition challenges in the property sector. For example, the Bank could encourage efforts by the private sector banking association to lobby for, and eventually pay service fees for, faster service response from the land and mortgage registries.

Mitigate the risk of real estate price bubbles that may be fuelled by rapid growth of housing loan finance. The Bank should take into account the risk that stimulating rapid growth in the supply of housing loans may contribute to rapid price rises in residential property if the supply of housing is constrained. The risk of demand-supply imbalances, while a normal feature of every real estate market, may be higher in transition economies where much land and real estate is held off the market by lack of privatisation, inadequate legal and institutional frameworks for property registration, and other supply-side constraints. The Bank could complement its housing loans projects with appropriate efforts to complete the privatisation and decentralisation of state-owned land and buildings consistent with the Bank's property sector policies and the Article 2 mandate to "assist the recipient member countries to implement structural and sectoral economic reforms, including demonopolisation, decentralisation and privatisation…"

Warning mortgage borrowers about market risk does not reduce the risk. It may be good practice to warn small borrowers about currency risks that they face when borrowing money in foreign currency or in local currency indexed to foreign currency. However such warnings do not mitigate the attendant risks faced by the borrower, in the form of increased debt service, or for the lender in the form of increased loan losses in case of devaluation. When lending to SMEs, a lender may select borrowers that are naturally hedged against exchange risk, but this is difficult to do in mass retail housing loans and is not market practice.

Client reporting requirements should contain the information needed for monitoring success. Operation reports often list the types of information about a project that the Bank will use to monitor achievement of objectives, transition impact and other elements of project performance. When such information must come from the client, it is important to incorporate a corresponding reporting requirement into the client's contractual reporting obligations.

Benefits of taking a relationship approach for environmental performance to FI sponsors with multiple investments. In developing new projects with existing FI clients, the Bank should build upon past investments in environmental training and environmental management systems previously established within the FI. This will further the environmental institutional development of the FI through reinforcement of the Bank's promotion of best environmental practices for FIs.

Recommendation on currency risks. In its routine monitoring of its investments in banks in the country, the Bank should assess the degree of each client bank's exposure to indirect credit risk, caused by loans in foreign currency or indexed to foreign currency, and to assess how each bank has measured the potential impact of such credit risks and mitigated them through borrower selection, increased capital allocations, or otherwise. It should also find out to what degree the country's banking supervisors may be carrying out relevant stress tests and learn the results of those stress tests because these are relevant to transition impact and to EBRD's management of its large exposure to banks in the country. Also, the Bank should consider the extent of its exposure given the high level of unavoidable, systemic indirect credit risk in the national banking system. It should assess the risks of assuming, along with the rest of the market, that the authorities will be able to prevent an unwanted devaluation from occurring.

Recommendations for increasing business volume. The market for housing loans demands funding of fixed rate loans for long tenors. The Bank should consider the degree of its commitment to encouraging housing lending by financial intermediaries and whether or not to use its competitive advantage in very long dated loans to extend very -erm loans for the purpose of housing loan financing in countries with sound legal and institutional frameworks. Such loans should enjoy good additionality even in central Europe and could contribute importantly to the development of the housing loans markets. They could be provided through a trust or other special-purpose structure that could purchase housing loans from banks, thereby limiting direct financial exposure to banks, as a prelude to eventual capital markets securitisation of housing loans.

In future housing loan finance projects, the Bank could consider providing additional financing, perhaps involving a donor-funded pricing incentive, to encourage sub-borrowers to make relevant environmental investments. The energy-efficiency unit has developed a similar approach for a bank intermediation project in one of its countries of operations. Such an "add-on" facility could increase the volume of the Bank's loans to the housing sector and bring valuable environmental benefits.