SUMMARY OF OPERATION EVALUATION

An SME Bank

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EBRD EVALUATION DEPARTMENT

European Bank
for Reconstruction and Development

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Executive summary

This summary of the Operation Evaluation covers the key points from an evaluation of two major TC operations in favour of a small privately owned bank in which the EBRD has an equity stake. The bank was formed from the merger of two smaller local banks with a very small market share. The first TC operation, an institution building plan (IBP), was related to the EBRD equity investment implemented over the course of three years after extensions. The second operation provided assistance with the implementation of an SME credit line (partially disbursed) originally intended to run for two years.

The Operation Evaluation evaluates the results obtained from the two interventions and finds that initial expectations were met only in part with considerable further effort required when the assignments ended. The principal reason for this was the failure on the part of the bank's main shareholder to recognise the need for fundamental change to aspects of governance, management and operations. In retrospect it appears the EBRD's initial needs assessment did not take into account sufficiently the extent of legacy problems that predated the EBRD's investment and the willingness and capacity of the main shareholder to address them. As a result the consulting inputs were slow to yield results. It appears also that progress was inhibited by a degree of overlap between the assignments and insufficient collaboration by the two teams of consultants.

The IBP is rated *partly successful* overall with *satisfactory* transition impact. The achievements recorded by the end of the IBP contract fell short of expectations, although there has been some success in building subsequently on restructuring and systems work initiated by the IBP. The SME credit line technical assistance is rated *unsuccessful* overall with *marginal* transition impact. It failed to build a viable SME loan portfolio. In the assessment of the Operation Evaluation team, the outcome of the TC operations was influenced by inadequate coordination of the tasks and deliverables of the two consulting teams. On balance bank handling is rated satisfactory to reflect the recovery efforts instituted by the corporate recovery unit through remedial action.

The key issues and related lessons concern securing the appropriate level of client responsiveness when deep institutional change is required and the effective management of complex interrelated consulting assignments. In cases such as this, it is important to address post-merger integration and build an effective working relationship with the main shareholder. The client's management team must possess or acquire the requisite skills to create value for shareholders. This demands major time commitment from the EBRD operation team and is likely to require Bank participation for a time in problem solving at executive management level in addition to representation on the supervisory board.

1. The TC operations and the related investments

1.1. The TC operations

The two TC operations included:

- one for assistance with the implementation of an Institution Building Plan funded by two donors, including a donor country and the EBRD; and,
- a second one for the design and implementation of an SME lending programme, funded by another donor country.

From the outset, the Bank contracted a consulting firm to provide assistance with a comprehensive IBP which was an integral part of the EBRD equity investment. The consultants completed field work over a period of 3 years.

The EBRD contracted a consulting firm to provide technical assistance to the bank over a 24-month period aimed at refining SME lending methodologies and related risk management systems including the training of loan officers and assistance with necessary organisational changes. The contract was terminated early by the EBRD. Remaining tasks were transferred to the original consulting firm forming part of the contract extension.

1.2. The related equity and loan investments

The TC operations were linked with the EBRD's acquisition of an equity stake in the bank and the provision of a credit line for on-lending to SMEs. The equity investment was approved in anticipation of the establishment of a new institution through the merger of two small locally owned banks with a common dominant locally owned shareholder.

Of the two tranches credit line only the first tranche was disbursed. The Bank has withheld disbursement of the second tranche because of persistent covenant breaches by the client.

1.3. Follow-on TC operation

Upon the completion of the TC operations that are the subject of this Operation Evaluation, it was decided that more work was necessary in particular to implement key risk management components of the IBP and to develop a coherent risk culture at the bank which encountered a serious worsening of financial performance in 2009. At the instigation of EBRD to help stabilise the bank and oversee risk management an individual expert was appointed as interim manager for a 12-month period, subsequently extended for a second 12-month period. The consultant has executive functions and authority within the bank as a member of the management board.

1.4. Recent developments

The EBRD Board was advised via three quarterly risk reports of concerns over the bank's performance and progress with the IBP against the background of continued friction among the main shareholder, its majority owner and the EBRD. A reservation of rights letter was sent by EBRD to the bank due to significant breaches of financial covenants. At the annual general meeting of the bank, a dividend was then declared to which the EBRD did not consent and in breach of provisions contained in the shareholders' and loan agreements. The EBRD notified the bank and its main shareholder in writing of the breaches and potential consequences.

1.5. Rationale and relevance of the TC operations

TC Com considered the TC request (TCR) for the IBP early on. The TCR explained that the institutional capacity of the merged entities was limited because of their lack of knowledge of modern banking practices. Technical assistance was needed to realise the synergies of the merger and build the business on a sustainable basis.

Assistance with the implementation of the SME credit line was provided under the donor financed TC umbrella of an SME finance framework. According to the original TCR considered by TC Com, the main rationale was to incorporate high quality SME lending as an integral part of the business activities of banks in a region characterised by a low level of intermediation.

The Operation Evaluation team considers that the rationale for the EBRD's interventions was sound with a high degree of relevance to the achievement of EBRD transition goals.

2. Achievement of objectives

The objectives were set out in the TCRs and in the terms of reference (ToR) for the two teams of consultants.

2.1. Assistance with the IBP

The IBP was an integral part of the EBRD's equity investment and was designed to focus assistance on:

- corporate governance;
- operational modernisation and upgrade;
- business development;
- institutional capacity building;
- risk management.

The consultants submitted a detailed inception report which included their initial analysis of the situation at the bank based on the first weeks of the assignment. The inception report set out a number of project phases with a detailed description of work streams, timelines and deliverables.

Progress was slow. Reports from the consultants evidenced lack of commitment to change by the main shareholder and lack of willingness or capacity by management to implement change in key areas. An IBP steering committee was formed at an early stage with members representing the main shareholder, the bank's management, the consultants and the EBRD. The minutes of the steering committee meeting held, almost two years after the beginning of the assignment, list "overdue activities" and "activities yet to be completed". The minutes illustrate the extent of work that remained to be done with three months left to run of the original assignment.

There were overdue activities in the fields of:

– legal and corporate governance	– IT	– back office
– internal audit	– controlling	– corporate division
– retail division	– treasury	– sales / marketing
– risk management	– HR	–

According to the steering committee there were other IBP "activities yet to be completed" that had not yet been featured in the work programme, in particular:

- Retail: branch network review
- Operations: procedures for managing foreclosed assets and property portfolio optimisation
- HR: incentives for staff innovation in product development
- Risk management: liquidity planning and training in quantitative and qualitative analysis
- IT: medium term strategy
- Internal audit: training in modern practices and review of credit risk management processes and procedures.

The terms of reference for the IBP consultant were then amended to clarify the focus that needed to be given to particular areas such as the development of a credit scoring system and aspects of risk management. Other terms and conditions of the contract remained unchanged, implying that completion by was still expected. The contract end date was extended, but with no increase in budget. The same consulting firm was awarded a one-year contract extension with a new budget.

The start of the contract extension coincided with the appointment of a new CEO with the designation of President of the Board of Directors, the management board. The new CEO set about reorganising the management structure and strengthening the skills set of management and staff with the assistance of the IBP consultants. The contract extension also confirmed and formalised the transfer to the IBP consultants of responsibility for continuation of the assistance with implementing the SME credit line.

The Operation Evaluation team understands that the consulting team withdrew early having utilised the agreed time allocation. In discussion with the Operation Evaluation team some senior staff of the bank stated that the departure of the consultants had taken them by surprise as they had been expected to remain on site for an additional 3 months in order to complete the documentation of some processes and follow through the implementation of some IBP procedures. This state of affairs seems to be confirmed by the steering committee presentation which listed 13 main activities with outstanding completion deadlines. Responsibility for guiding completion and follow through was assumed by the individual expert appointed to the management board.

In the Operation Evaluation team's assessment, the IBP objectives were *partly achieved*.

2.2. Assistance with the implementation of the SME credit line

TC Com approved a framework umbrella covering financial markets where TC funds were needed to develop local banks' lending skills including implementation of SME lending programmes, staff training and systems development. Under the framework TC funds for the bank were provided by a donor country contributing to private sector development.

The main objectives were to:

- implement an SME lending programme and organisational or operational changes necessary to ensure successful implementation;
- provide institution building and staff training;
- represent EBRD in making sub-loan decisions, portfolio monitoring and loan recoveries.

The technical assistance accompanied a credit line for on-lending to SMEs, anticipated to be disbursed over two years. The first tranche was released after the EBRD waived non-compliance of conditions relating to ratios in respect of liquidity, overall arrears and operating expenses. The Bank hoped that its forbearance would create conditions for the bank to develop a sound SME lending methodology while simultaneously implementing the IBP. The hopes were not realised.

The third quarterly report delivered by the SME consultants listed 26 sub-loans amounting, one of which was reported to be over 60 days in arrears. The quality of the sub-loan portfolio deteriorated during 2008 and the EBRD declined to release the second tranche of the credit line. As noted above, the contract with the original SME consultants was terminated with the IBP consultants taking on the outstanding tasks. The over-30 days arrears ratio on the sub-loan portfolio reportedly reached high levels before being brought down again the following year. The main reason for the high arrears level seems to have been poor collection discipline rather than bad lending as such. There was a further later spike in arrears, apparently again because of lack of attention to recoveries. After the new consultant specialist joined the management board, the collection of arrears improved rapidly under his influence. Arrears were reduced to four loans. The consultant specialist noted in his report on activities that the reason for the bad loans was a matter of bad arrears management and focus

In summary it appears that the first team of SME consultants did not succeed in instilling good collection discipline and that the IBP consultants paid insufficient ongoing attention to collection discipline after they took over responsibility for the SME assignment. The most recent credit review summary by the EBRD credit department observes that the bank has been suffering for years from poor asset quality (including legacy distressed assets and related party exposure) with traditionally weak underwriting standards. In the assessment of the Operation Evaluation team, the objectives of the SME credit line technical assistance have not been achieved.

2.3. Fulfilment of objectives rating

Fulfilment of objectives is rated marginal for the IBP and unsatisfactory for the SME TC assignment. This assessment is based on the bank's failure to meet the standards necessary for release of the second tranche of the credit line, and on the size and significance of the tasks remaining to be completed at the end of the IBP consultant's contract extension. To balance this rating the Operation Evaluation team notes that considerable improvements were observed during the evaluation visit, many of them being due to work done by the individual expert appointed to the management board at the behest of the EBRD, cooperating with the new CEO. Maintaining progress is likely to depend heavily on satisfactory resolution of governance issues arising from the influence of the main shareholder.

3. Transition impact and additionality

3.1. Transition impact of the institution building plan

[**Contextual note**: The transition impact objectives of the equity investment were to support the merger of two banks, to encourage competition and banking penetration, and to promote foreign investment through eventual sale to a strategic investor. Although this evaluation does not extend to the equity investment, it is worth noting that successful completion of the IBP was one of the transition impact monitoring benchmarks cited at approval of the equity investment.]

The TC request for the IBP rated the transition impact potential *excellent* with *high* risks. The potential was seen to derive from improvements in corporate governance and business practices with the possibility of a strong demonstration effect in a market where corporate governance problems were a common issue. The risks to transition impact related to the bank's commitment to change, or in other words the willingness of the main shareholder to align its interests with those of the Bank.

The EBRD operation team prepared donor completion reports in the Bank's consultant assignment reporting system covering the initial IBP contract and the extension. The reports observed that "the IBP was not fully implemented, mainly due to the weak corporate governance and resistance of the main shareholder to undertake some painful, but necessary changes." The reports also noted the lack of willingness in the bank to introduce deep changes in the risk management system and poor implementation of the new marketing, sales and product development strategy, although positive achievements were recorded in organisational and operational restructuring.

During the evaluation mission, the Operation Evaluation team interviewed the heads of the principal functions touched upon by the IBP. The interviews confirmed that the IBP consultants were effective in influencing change in some key areas, especially the treasury function, branch network organisation and some basic HR functions. By contrast, the new CEO stated that he found on his arrival in the post that the IBP consultants were poorly focused and their activities not coherently prioritised. He insisted on further streamlining of the organisation structure which was then approved by the bank's board.

Based on file review and interviews conducted during the Operation Evaluation visit, the key unresolved issues included:

- influence of the main shareholder on management and operations, exercised through family connections;
- the legacy burden of foreclosed assets that are not revenue earning, although there was progress in realising some foreclosed assets over the last year;
- the high cost base, exacerbated by non-arm's length rental payments to the main shareholder;
- lack of progress in developing product and branch profitability models;
- most recently, the main shareholder's insistence on voting a dividend without EBRD approval.

3.2. Transition impact of the SME credit line technical assistance

Transition benchmarks for the SME technical assistance were set out in the consultant terms of reference (ToR) under four categories, namely:

- Institution building through training and systems development;
- financial intermediation through on-lending the credit line;
- operating efficiency through building a quality sub-loan portfolio;
- sustainability, to be demonstrated by the bank extending SME loans with own funds in addition to the EBRD credit line.

These benchmarks were tabulated in an annex to the ToR. Following the termination of their contract, the original team of SME consultants submitted a final report in which they included a table detailing progress with implementation of the TI benchmarks. A number of key objectives were not achieved. In particular:

- The bank did not accept the credit scoring system proposed by the consultants;
- there was no progress with decentralising credit approval authority;
- The EBRD withheld the second tranche of the credit line because of the poor quality of the sub-loan portfolio and the client's non-compliance with other conditions.

Responsibility for developing the credit scoring system was transferred to the IBP consultants, as recorded in amended ToR. Although the final report of the IBP consultant makes no mention of the credit scoring system, the steering committee report includes the observation that credit analysis and scoring models for branch level approval have been implemented throughout the bank's branch network (retail, SME, corporate).

As noted above, responsibility for following through to completion the remaining tasks associated with the SME credit line was formalised in the contract extension. In addition to accomplishment of the outstanding IBP goals, the contract called for implementation of the SME transition impact objectives as best as reasonably possible. The consultant's final report was to contain an overview of the implementation of the transition impact benchmarks. The consultants submitted to EBRD a final report covering the entire period. This final report made no mention of transition impact and contained no assessment of progress in reaching the benchmarks. The last steering committee report contained a section on SME credit line implementation which recorded that the sub-loan portfolio 30-day arrears ratio was quite high, indicating that the transition aspirations were far from being met.

With regard to systems, the head of risk commented to the Operation Evaluation team that the bank was only now finalising the documentation of procedures for risk management.

3.3. Transition impact rating

The IBP consultant completed work on site under the contract extension. The interim manager appointed has been able to build on the organisational restructuring and systems work initiated by the IBP consultant. For this reason, although the achievements recorded by the end of the IBP contract fell short of expectations, the transition impact of the IBP TC is rated *satisfactory*.

The SME credit line technical assistance failed to build a viable sub-loan portfolio or develop a coherent risk culture at the bank. The strengthening of risk management practices became an urgent task for the interim manager. The transition impact of this TC operation is rated *marginal*.

To balance this assessment it is important to note that, although the transition achievements of the TC operations under review were below expectations, some important momentum has been maintained through the efforts of the interim manager, through the involvement of the EBRD's corporate recovery unit and through the contribution of EBRD appointees to the bank's supervisory board. Remaining transition potential is rated *good* provided the momentum of change is sustained. The risk to transition potential is assessed as *high* to *excessive* in light of ongoing issues of governance.

3.4. Additionality

The additionality at appraisal of the technical assistance is *fully verified*. The TC operations offered the bank essential elements of institutional support which were not available from other sources.

4. Bank handling

4.1. General remarks

It is apparent from the early documentation of the TC operations, particularly the consultants' terms of reference, that the EBRD operation team put a great deal of thought into identifying the bank's needs. Reports from the consultants in the early stages display a flexible approach to the assignments, with detailed scoping of the client's precise needs after some weeks' familiarisation to identify the management and skills gaps. Nevertheless, it appears with hindsight that the willingness of the main shareholder to support institutional and operational changes could have been more carefully assessed; and that the EBRD could have coordinated the consulting inputs more effectively.

4.2. Assessing the sponsor's commitment to change

The main shareholder of the bank remains unchanged. The General Manager is also Chairman of the Supervisory Board. This person and his associates had exerted influence on the two banks which were merged to form the bank and they continue to influence the governance and operations of the bank through family members and related parties in a significant number of management and staff positions. The OpsCom documentation preceding the approval of the equity investment indicates that the banking team and other departments were aware of these weaknesses and of the need for significant reorganisation within the merged bank.

The Operation Evaluation team acknowledges that elements of the TC operations under review were intended to address the issues arising from these observations. Subsequently, as it became apparent that insufficient progress was being made, the EBRD was instrumental in bringing about change in the composition of the management board. The Bank's corporate recovery unit became closely involved early on and was effective in persuading the main shareholder to implement some important changes and give more effort to the resolution of legacy issues involving long-standing legal disputes and a sizable portfolio of foreclosed assets.

4.3. Coordination of consultant inputs

The terms of reference of the two consulting teams overlapped in some important areas. Under the heading "Business Development", the IBP consultants were to assist the bank with the active development of the corporate and retail banking business. The specification stated that the bank should focus its corporate business more towards SMEs and micro companies, with proper segmentation of the client base and staff with specialist skills for each type of client. The Consultant was to assist the bank in this process by providing advice and training throughout the assignment particularly focusing on optimal management of SME clients and ensuring clear and relevant business targets for each client are met." The SME credit line consultants soon became aware of the overlap when they began their assignment around three months after the IBP consultants. Their inception report, submitted after one month of activity, stressed the importance of cooperation between the two teams. The SME consultants changed the composition of their team after questions were raised about quality of performance. Problems with the quality of the bank's management and the attitude of the main shareholder had not been resolved which in all probability added to the difficulty of achieving effective cooperation between the teams of consultants. As previously noted, it was decided to terminate the contract of the SME consultant and transfer the remaining tasks to the IBP consultant.

From interviews with various participants and review of consultants' reports, the Operation Evaluaiton team concludes that stronger results might have been obtained earlier if the EBRD had made a concerted effort to differentiate and coordinate where appropriate the consultants' activities. It appears likely that the presence of parallel consulting teams aided the incumbent management and the main shareholder in delaying the adoption of proposals for change.

4.4. The involvement of the corporate recovery unit

It was apparent that remedial action was required to protect the EBRD equity investment. Accordingly, the corporate recovery unit became involved. Under this mode of operation, corporate recovery assumes the role of team director, leaving the existing operation leader in place. The unit has given regular advice both to the operation team and to the interim manager. As well as providing input on dealing with outstanding crucial issues at the bank, the unit has engaged with the main shareholder and the supervisory board, seeking to resolve contentious issues and manage the troubled relationship.

4.5. Rating of bank handling

In the Operation Evaluation team's assessment the risk to a successful outcome of the TC operations under review was increased by the failure to coordinate fully at the design and contracting stage the tasks and deliverables of the two consulting teams. Latterly, the skilful involvement of the corporate recovery unit has led to remedial action and recovery efforts that may result in some success in terms of institution building if the main shareholder can be persuaded to adopt a more reasonable course of action. On balance bank handling is rated *satisfactory*.

5. Key issues and findings

5.1. Securing client commitment to institutional change and managing complex TC assignments

The key issues that emerge from this TC evaluation concern (i) understanding the extent of client commitment to institutional change and seeking to mitigate the risks when it appears that commitment may be less than wholehearted; and (ii) effective scoping and management of complex TC assignments.

The institution building plan appeared to begin strongly with the consultants identifying in their inception report the areas in which the bank needed expert assistance and setting out clearly defined work streams. Implementation of both the IBP and the SME credit line soon encountered obstacles thrown up by the reluctance of the main shareholder and incumbent management team to accept change. Matters began to then improve when a new CEO was appointed, although it soon became apparent that there was still a need to inject professional banking expertise in the area of risk management. This led to the involvement of the corporate recovery unit and the appointment of an interim manager at senior level. Developments have underlined the value of regular communication between EBRD and the client to maintain some momentum of change even when the main shareholder is in confrontation with EBRD.

5.2. Findings

5.2.1. Evaluating shareholder and management readiness for change

When preparing an institution building plan, the operation team must assess the willingness and capacity of the client to accept and implement institutional change. The assessment should clearly identify any matters that might jeopardise the success of the assignment such as the existence of legacy issues that may impede business growth and the influence of existing shareholders over management.

5.2.2. Scoping TC to counterbalance the vested interests of a dominant shareholder

In the present case the influence of a key individual representing the main shareholder was detrimental to the timely implementation of the technical assistance programme, and the client company's business performance. Especially in post-merger situations it is important to build a management team with the requisite skills to create and realise value from TC interventions. This may require EBRD participation for a time in problem solving at executive management level in addition to representation on the supervisory board. Where required the TC scope should be expanded to encompass provision of the necessary expertise, for example by appointing an interim manager with experience of the region and its business culture who is capable of counterbalancing vested interests.

5.2.3. *Aligning client interests with EBRD transition goals*

In the absence of a strategic sponsor whose interests are aligned with EBRD transition goals, the Bank should seek additional leverage through which to overcome any ongoing resistance to institutional change and improvements in governance. Such leverage might be secured by:

- requiring the client to contribute to TC costs from the outset;
- increased oversight by the EBRD operation team to control consulting inputs and monitor progress;
- progressively phasing long-term consulting assignments so that the commencement of successive phases is conditional on successful completion of prior phases.

5.2.4. *Effective coordination of consulting inputs*

If it is necessary to engage separate teams of consultants in parallel, their respective tasks must be defined and coordinated clearly. In such cases it will be incumbent on the EBRD operation team to monitor progress closely and ensure that the consulting teams cooperate effectively.

5.2.5. *Partner bank features and attributes*

With respect to implementing an SME programme, it is useful to recall a previous evaluation of an SME lending framework which identified a number of partner bank features and attributes considered essential to secure the success of such a programme.