The Project

The Project concerns two facilities provided by the EBRD to a bank – a mortgage facility in 2005 (approximately €8.2 million) and a subordinated loan in 2008 (approximately €41 million).

The mortgage facility was provided for long-term on-lending to residential mortgage borrowers and was fully disbursed. Half of the mortgage facility was syndicated to another development finance institution.

The subordinated loan was provided to supplement the Tier II capital of the Company during a period of accelerated growth in all core loan segments and was supported by a wide-reaching payment undertaking from the parent bank. Loss of the parent's investment grade rating in April 2009 entitled the EBRD to call the undertaking. The EBRD agreed not to exercise its rights on the condition that the pricing would be increased. The country's regulatory authorities rejected any possibility of an additional margin as inconsistent with the Tier II capital ranking of the subordinated debt. A fee was therefore applied by the EBRD on the parent bank, in consideration of the EBRD not making demand under the payment undertaking.

Overall Assessment:	**Unsuccessful** **(Overall Ratings: Highly Successful, Successful, Partly Successful, Unsuccessful)**

These Projects were *Unsuccessful* overall, as neither achieved their objectives and transition impact was *Unsatisfactory.* Project rationale was to support the business growth of the client and stimulate competition in financial intermediation. Fulfilment of objectives was *Marginal* as some objectives were only partially achieved and others not achieved or abandoned in the crisis environment. The failure to establish good lending practice in mortgage finance and the unsustainable growth model facilitated by the subordinated loan (Tier II Capital), resulted in *Unsatisfactory* transition impact. Project Financial Performance was *Marginal* due to loan losses, the unsustainable business model and capital injections required. Bank Handling was *Satisfactory*. The Bank's Investment Performance was *Satisfactory* and reflects the incremental pricing achieved for declining credit quality of the parent company.

CATEGORY	RATING	COMMENT
ADDITIONALITY	■■■■	The EBRD's additionality is *Verified in All Respects*. At the time of approval, there was an absence of market-based long-term (7-10 years) funding for senior and subordinated debt in this country of operations.
EFFECTIVENESS		
Achievement of Objectives	●●●○○○	The achievement of project objectives has been *Marginal.* 1. **Long-term funding for mortgage lending (*achieved*).** In the two years prior to the mortgage facility, the Company developed a mortgage portfolio of just US$ 35 million (total loan assets approximately US$ 630 million), on loan terms as short as five years. Funding constraints were identified as an issue for

		growth. The mortgage facility was incremental at the time of the approval in supporting mortgage lending growth. Post-approval, project impact was overshadowed by the speed of growth of mortgage lending, which exceeded US$ 500 million by the time the mortgage facility was fully disbursed. Mortgage lending went on to reach over US$ 1 billion by early 2009. 2. **Prudent financing of residential mortgages (*not achieved*).** There was no covenant or agreement in principle to implement the EBRD's Mortgage Lending Guidelines outside of the immediate subloan portfolio. In 2009 the Company's mortgage arrears stood at around 30 per cent of the mortgage portfolio. Ninety per cent of its mortgage loans were hard currency denominated, which left the Bank exposed to some 50 per cent devaluation and the rise in unemployment in the country of operations. 3. **Raise Tier II capital and diversify funding to expand operations (*partly achieved*).** At the time of approval, the Company had ambitious plans to grow the bank threefold in three years. Additional capital was a strategic imperative and was fulfilled by approximately €41 million subordinated loan, providing capital for additional potential lending capacity of approximately €635 million. The frailty of the business model was subsequently exposed in the current economic crisis and the Company became completely reliant on the parent company for capital support and funding in 2009. The EBRD entry objectives of asset growth and funding diversification are no longer applicable and Tier II capital support is now about helping the Company to sustain losses from deteriorating assets. 4. **Support market expansion and competition (*partly achieved*).** For a period of time (mid-2007 to late 2008), some of the small and medium-sized enterprise (SME), retail and mortgage lending benchmark objectives were being met or were well in process. Post-crisis, these objectives are no longer applicable.
PROJECT FINANCIAL PERFORMANCE	●●●○○○	Project Financial Performance was *Marginal.* Non-performing mortgage loans are above 30 per cent and there were significant losses in 2009.
EFFICIENCY		
BANK HANDLING	●●●●○○	Bank Handling was *Satisfactory*. Project selection, appraisal, structuring and

		documentation were sound. Growing issues of systemic risk in the country's financial sector (particularly in foreign currency and mortgage lending) were not reflected in project design or implementation. There was no evident impact of the EBRD's good practice guidelines upon the wider mortgage business undertaken by the Company.
BANK'S INVESTMENT PERFORMANCE	●●●●○○	The Bank's Investment Performance is rated *Satisfactory* and reflects the incremental pricing achieved for declining credit quality of the Company.
IMPACT/SUSTAINABILITY		
TRANSITION IMPACT	●●○○○○	The failure of transition objectives around good lending practice and the unsustainable growth model facilitated by the subordinated loan capital increase led to an *Unsatisfactory* rating for transition impact. There are further downside transition risks in the event of deterioration of the loan portfolio.
ENVIRONMENTAL AND SOCIAL IMPACT	●●●●○○	Environmental obligations were limited in scope but consistent with the Bank's approach. The level of Environmental Performance was *Satisfactory*. There are issues with the definition and implementation of environmental commitments. The nominal adoption of Environmental Procedures for EBRD Intermediated Lending through Local Banks and provision of regular reporting points to *Some* level of environmental change.

General ●●●●●● Excellent ●●●●●○ Good ●●●●○○ Satisfactory ●●●○○○ Marginal ●●○○○○ Unsatisfactory ●○○○○○ Highly Unsatisfactory	**Additionality** ■■■■Verified in all respects ■■■□Verified at large ■■□□Verified only in part ■□□□Not verified

Lessons Learned

In future, regulators are likely to require that terms and conditions of Tier II capital subordinated loans are fixed for their duration and cannot be varied, even by mutual consent between the lender and borrower (or guarantor). This includes the absence of onerous conditions such as upward ratchets in pricing related to credit rating or other support, such as put options to a parent company. To qualify as Tier II capital, the EBRD's subordinated debt transactions will have to reflect this evolution in the regulatory approach.

Tier II capital has the potential to support significant balance sheet expansion and capital support for a bank, but the EBRD should not rely on making the capital available alone as the means to achieve transition objectives. In pursuit of transition objectives, the EBRD could be seeking commitments in principle from

borrowers such as a memorandum of understanding or version of the institution capacity building agreement on how the bank is to develop and its key policies.
Subloan reporting should be established from the outset. Early establishment and reporting of the subloan portfolio will facilitate comparison between performance of loans under the EBRD's criteria, compared to those of the client. Where the subloan portfolio demonstrates stronger performance than the overall portfolio, this may help promote the case for prudent lending policies. Even where lending practices are not covenanted to apply to the wider portfolio, data should be collected to enable comparison.
In fast-growth environments, demonstration of results from a sub-oan portfolio under a credit line are unlikely to influence lending policies. Close cooperation with the borrower is required to promote the adoption of good practice. Incentives could be provided, for example, if good practice or key performance indicators are achieved. Even so, there is a limit to how much engagement a partner bank will accept in fast-growth markets where fear of not maintaining market share may outweigh the willingness to adopt prudent lending practices. In these circumstances, only regulatory intervention may be able to hold back overheating markets, which emphasises the role to be played by policy dialogue.