Operation Evaluation

Summary

A financial institution in eastern Europe

A private sector investment operation

March 2012

Evaluation department (EvD)

European Bank
for Reconstruction and Development

Executive summary

The subject of this evaluation, a large state-owned bank, primarily serves corporates focused on exports and import substitution. In recent years it has expanded its small and medium-size enterprise (SME) portfolio, as well as participating in the EBRD's energy efficiency and trade facilitation programmes.

As part of the EBRD's crisis response in the country of operations in 2009, the Board approved a subordinated loan to the bank for up to 10 years and also a syndicated loan. The transactions support efforts by the government, which injected capital between 2008 and 2010 and also provided substantial liquidity support to the bank. In this context the primary purpose of the EBRD facilities was not so much to boost the bank's capital and liquidity as to demonstrate confidence in a systemically important bank and help the client to maintain contact with the international markets.

A number of measures were taken to mitigate the perceived credit and transition risks of providing subordinated debt to a state-owned bank. These included a set of covenants to enable the EBRD to monitor the bank's involvement in state-related activities and a proposal that the EBRD would participate as an observer at meetings of the client's supervisory council. To date the covenants have been met; however the proposal to grant observer status has not been implemented.

The evaluation finds that the transactions were a timely contribution to efforts to signal confidence in a systemically important, well-managed institution. Viewed together as a crisis response package, the operations are rated *Successful* overall. Principal findings relate to the issue of observer status on the supervisory council, the use of proceeds of subordinated debt and the value of working with state-owned banks to pursue transition objectives in a less developed market.

Table: Ratings summary

Overall assessment	♦ ♦ ♦ ◊ Successful
Additionality	■■■■ Fully Verified
Company financial performance	●●●●○○ Satisfactory
EBRD investment performance	●●●●●○ Good
Achievement of objectives	●●●●○○ Satisfactory
Transition impact	●●●●●○ Good
Environmental performance	●●●●●○ Good
Bank handling	●●●●●○ Good

Rationale and relevance

Additionality

■■■■ Fully Verified

The primary rationale at approval was to provide additional Tier II capital to a systemically important bank alongside capital injections by the state to bolster confidence in the banking sector as a whole. The lack of available Tier II funding from other parties and general absence of capital market funds confirmed the EBRD's additionality at appraisal. Additionality is *Fully Verified*. The syndicated loan was the first such transaction for a bank in the country since the onset of the crisis.

Effectiveness

Achievement of objectives

●●●●○○ Satisfactory

The subordinated loan

The wider objective was to complement steps already taken by the government to increase the bank's capitalisation and promote lending to the real economy. This was achieved. More specific objectives included:

– Financing of energy efficiency projects in accordance with eligibility criteria, in addition to the existing credit line from the EBRD. The anticipated additional demand for energy efficiency financing has not yet materialised.

– Lending to finance export-oriented companies in conjunction with the World Bank's Export Development Programme. This was achieved.

– The bank's application of some of the proceeds to participate in the recapitalisation of locally owned commercial banks and companies through equity participation. Economically viable opportunities for equity investment in commercial enterprises have not materialised.

The syndicated loan

The goals were to send a positive signal to other financial institutions regarding the bank and the market, and to refinance part of its substantial external repayment requirements in 2009. Specific targets included:

– The return of the bank to international capital markets without international financial institution (IFI) support, which was achieved with the issuance worth eurobonds.

– The continuation of the business relationship with B-lenders through bilateral and trade finance facilities. The bank has continued its relationship with other banks through trade finance facilities.

Impact

Overall transition impact

●●●●●○ Good

The subordinated loan

The transition impact of the subordinated debt was seen to come from strengthening the capital base of the bank, which should allow the bank to expand lending activities to the real sector, especially for energy efficiency and export-oriented investments. There has to date been insufficient interest from sub-borrowers for energy efficiency financing and no opportunities to participate in the recapitalisation of other enterprises have been identified. The bank has, however, maintained its lending to the real economy, including SMEs, when many private banks in the country have seen their portfolios contract while dealing with non-performing and restructured loans. The evaluation confirms the *Good* transition impact rating for the subordinated loan. The remaining transition potential is also rated *Good*, with *High* risk.

The syndicated loan

The evaluation confirms the *Good* transition impact rating for the syndicated loan. Although the signed loan amount was below the original target, six participants joined in the B-loan. As the A and B loans have been repaid in full from the bank's liquid funds, there appears to be no further transition impact potential associated with the syndicated loan.

Efficiency

Bank handling

●●●●●○ Good

The value of a counter-cyclical response

The bank's senior management told the evaluation team that the EBRD had been the most proactive among international institutions in 2009 when others were much slower to develop a response to the crisis. The contribution of the EBRD was acknowledged by a leading economic research group, which noted the increased activity during the crisis and stated that counter-cyclical behaviour was an important element of financial stabilisation.

In this context it appears reasonable to conclude that the EBRD 2009 subordinated debt and syndicated loan helped to pave the way for the success of the eurobond issues in the following year.

The cost of a counter-cyclical crisis response

In discussion with the evaluation team, the bank's management stated that they understood and accepted that subordinated debt carried a higher cost because of the longer tenor and risk premium. They also accepted that the EBRD's willingness to make the funding available at the height of the crisis warranted an element of additional cost.

They argued, however, that the very high cost of the subordinated debt made it unattractive to use the proceeds for energy efficiency financing, especially in the context of falling net interest margins overall. In other words, they consider the pricing to be prohibitively high in current market conditions.

The question remains whether the EBRD did not, in fact, underprice the subordinated loan. As noted by the Bank's Credit department at appraisal, legislation in the country does not allow subordinated debt to be priced above a set margin. Credit expressed concern that this pricing level should be recognised as insufficient in normal commercial terms given the prevailing circumstances. Although the Board document did not mention the favourable pricing, it made clear that the subordinated loan was "an integral part of the EBRD's systemic response to the financial crisis in the country focusing on participation in the recapitalisation of viable and systemically important banks…".

Findings and recommendations

Working with a state-owned bank to maintain support for the SME sector

The bank has a solid corporate franchise, providing investment loans to mostly large and mid-sized corporates and has expanded its SME business over the past decade.

During the crisis the bank received very substantial capital and liquidity support from the government, becoming the second largest bank in the country while most other banks have had to retrench in varying degrees to deal with the burden of non-performing loans and restructuring.

It is legitimate to ask whether support for the bank has been at the expense of eroding the capacity of private banks to service the SME sector. The bank was one of a small number of banks that continued SME lending during the crisis. Lending by most banks (especially to SMEs) was relatively stagnant during 2010, reflecting both higher risk aversion and lower absorption capacity among businesses. The experience suggests that using a state-owned financial institution as intermediary can have strong potential for positive impact in a less developed market, provided the institution is well managed and operates on a commercial basis.

The issue of observer status on the supervisory council

At appraisal, the EBRD Credit department was concerned that the risk of political interference in the bank remained and expressed the view that an EBRD nominee on the supervisory board should be a requirement to prevent directed lending and help increase transparency and credit quality. The Banking team indicated that it would not be possible for the EBRD to secure the appointment of a nominee to the board. Instead, the EBRD would monitor the bank's involvement in state-related activities through a set of covenants and by participating as an observer at the meetings of the bank's supervisory council. The EBRD requested, but was not granted, observer status on the supervisory council.

It may be that the client's management gave an undertaking that they were not in a position to fulfil. It is perhaps not surprising, given the finely balanced composition of the supervisory council, that the request for observer status was declined. The evaluation team considers that it would have been more prudent to obtain prior confirmation from the supervisory council that it agreed to grant observer status to the EBRD; or to have been more circumspect in advancing this as a risk mitigating factor in the Board document.

Use of proceeds of subordinated debt

In the event, the financing of energy efficiency projects did not reach the target, while lending to export-oriented companies exceeded the target. The client has argued that the higher cost of the subordinated loan makes it unsuitable for on-lending to corporate customers.

It is important to keep in mind that when the Bank secures a client's promise in respect of use of proceeds that cannot be covenanted as a legally binding commitment because of the nature of the instrument, the Bank is relying on leverage based on reputation and relationship value.

General

●●●●●● Excellent
●●●●●○ Good
●●●●○○ Satisfactory
●●●○○○ Marginal
●●○○○○ Unsatisfactory
●○○○○○ Highly Unsatisfactory

Extent of environmental change

✱✱✱✱ Outstanding
✱✱✱∗ Substantial
✱✱∗∗ Some
✱∗∗∗ None/Negative

Overall performance

♦♦♦♦ Highly Successful
♦♦♦◊ Successful
♦♦◊◊ Partly Successful
♦◊◊◊ Unsuccessful

Additionality

■■■■ Fully Verified
■■■□ Mostly Verified
■■□□ Partly Verified
■□□□ Not Verified