

March 18, 2010

H.E. Dr. Igor Lukšić
Deputy Prime Minister and Minister of Finance
Stanka Dragojevića 2
Podgorica, Montenegro

Mr. Ljubiša Krgović
Governor
Central Bank of Montenegro
Bulevar Svetog Petra Cetinjskog 7,
Podgorica, Montenegro

Dear Sirs:

***Re: Financial Sector Development Policy Loan (P116787) –
Status of prior actions***

With this letter I would like to draw your attention to several critical aspects concerning the implementation of prior actions for the potential Financial Sector Development Policy Loan (FSDPL) to the Government of Montenegro. As you will recall from the latest mission Aide-Memoire letter (dated February 3, 2010), the World Bank would need to see evidence of tangible progress towards completion of the prior actions, as defined in the Aide-Memoire letter, in order to proceed further with appraisal and negotiations for this loan. Based on the information received by our team from the staff of the Ministry of Finance (MoF) and the Central Bank (CBCG), it appears that substantial (but not sufficient) progress has been made on two out of three sets of prior actions, as follows.

Financial sector laws. We understand that MoF and CBCG have by now agreed on the final drafts of the five pieces of legislation (amendments to the Law on Banks and the Bank Bankruptcy and Liquidation Law, and new laws on the Central Bank, Deposit Protection Fund, and Financial Stability Council), incorporating the substance of comments received from the WB and the IMF. Furthermore, we have been informed that these draft amendments and new laws are expected to be submitted for Government's approval by the end of this month and for consideration by Parliament shortly thereafter. We would appreciate it if you would kindly share with us the final versions of these documents as soon as approved by the Government.

Assessing systemic banks. We have been informed by CBCG's supervision department that on-site examinations and stress tests of systemic banks are proceeding according to the agreed schedule. We would appreciate receiving from CBCG the copies of the final supervisory action plans for systemic banks that had undergone on-site examinations by CBCG as soon as these become available.

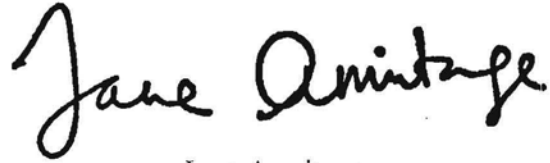
Prva Banka. The main impediment to meeting the loan timetable remains the need to formulate a clear strategy for the resolution of Prva Banka. It is still unclear to us when the resolution strategy will be formulated, and what form that strategy would take. While we listed a rather broad range of potential resolution scenarios in the above-mentioned Aide-Memoire letter (including both private and public solutions), the most urgent task remains the completion of an independent and up-to-date assessment of Prva Banka's condition, on the basis of which the resolution strategy will be determined. We understand that PwC has refused to complete the special diagnostic audit on the grounds of lack of cooperation from the bank. At the same time, Prva Banka's management expects that a regular 2009 audit to be conducted by Deloitte will demonstrate the drastic improvements in the bank's financial position made in the second half of 2009.

Although the 2009 report could in principle be considered in lieu of the special audit that PricewaterhouseCoopers (PwC) was unable to complete, we would recommend that CBCG only accepts this report if Deloitte's scope of work for the statutory audit follows in substance the extended diagnostic terms of reference as agreed with PwC, but with the financial report date changed to 31 December 2009. This extended scope of work is required due to the well-documented liquidity and capital adequacy problems experienced by Prva Banka in 2009 (which necessitated the measures imposed on Prva Banka by CBCG), and the need to validate the negative results of the draft PwC diagnostic report. To ensure appropriate quality controls in this complex and sensitive exercise, we would also expect that the contract is co-signed by a reputable Deloitte office from EU jurisdiction, and the auditor's team includes senior Deloitte staff from outside Montenegro (similar to the arrangements made with PwC). Finally, PwC should be given an opportunity to complete the regular 2008 audit of Prva Banka, without which 2009 audit could be heavily qualified. We understand that CBCG has requested the 2009 audit contract from Prva Banka for comments, and we would appreciate receiving a copy as well. Please note that in the absence of the above mentioned arrangements, it would be difficult to accept the results of 2009 audit report at face value.

We would also like to draw your attention to the recommendations contained in the previous Aide-Memoire letter regarding the state's direct and indirect exposure to Prva Banka via very large deposit balances held at the bank. We expect that prior to negotiations the authorities will address the inherent conflict of interest between Prva Banka's ownership structure and the bank's dependency on the state entities for its funding, by adopting a time-bound plan for withdrawal of state-related deposits. We remain open to discussion of the specific terms of this plan, which to a large extent will depend on the choice of resolution mechanism.

We hope to see accelerated progress on the prior actions in the coming weeks, and look forward to receiving the requested documentation.

Sincerely,

A handwritten signature in black ink that reads "Jane Armitage". The signature is written in a cursive, flowing style.

Jane Armitage
Country Director and Regional Coordinator
for Southeast Europe
Europe and Central Asia Region

cc: Mr. Rudolf Jan Treffers, Executive Director, The World Bank