by the CBCG. In the case of CKB, the parent bank (Hungary's OTP) is expected by CBCG to make a formal decision to provide the required additional capital no later than June 10, with the capital injection to be completed by August 2010. Discussions with CKB management provided assurances that OTP plans to provide the required capital within the time frame specified, but is negotiating with the CKB the final amount required given the differences between the Montenegrin provisioning rules and IFRS (the present supervisory strategy calls for €35 million additional capital). The next round of full scope inspections of all three banks is planned for 2nd and 3rd quarters of 2010.

7. *Next steps*. The CBCG has agreed to provide the mission, on a monthly basis, with an update on the implementation of supervisory strategy for each systemic bank. Confirmation that agreed additional capital is being provided by parent banks in a timely manner, including in the case of CKB/OTP, would be needed in order for the WB team to move forward with presentation of the proposed FSDPL to the Regional Operations Committee and, later on, to the Board of Directors.

Dealing with Prva Banka

8. ***Current status.*** The mission met with the CBGC inspection team responsible for the ongoing full scope examination of Prva Banka (PB) as well as with the senior management of both CBCG and PB. The mission was informed that CBCG intends to finalize the inspection report by end May, following (a) meeting with PB's statutory auditor for 2009 to discuss the respective findings; and, (b) discussion of the draft inspection report with PB management. The mission again requests that it be provided with a copy of the scope of work and methodology used by PB's statutory auditor for 2009.

9. The mission team received assurances from the senior management of PB that the latter would work with CBCG on capital and liquidity management plan reflecting the findings of on-site examination and statutory audit for 2009. At the same time, the management of PB continues to assert that the bank is more than adequately capitalized, profitable, and liquid. While the mission acknowledges the management's efforts to collect loans over the past year, its assertions regarding the bank's capitalization and profitability stand in stark contrast to the preliminary findings of the CBCG inspection (using financial statements as of 28 February 2010), the draft results of the diagnostic performed by PricewaterhouseCoopers (PwC) (using financial statements as of June 30, 2009), and the estimates made by other large commercial banks regarding the impact of decline in the real estate market on their loan portfolios (which are broadly consistent with the PwC findings and the CBCG's preliminary results). Collectively, these indicators point to a probable need for PB to record additional provisions in the order of 20 to 30 percent of its loan portfolio, which would render the bank deeply insolvent even under the most optimistic assumptions.

10. In addition to the apparent capital deficiency of PB, the mission remains deeply concerned regarding the size of the state's direct and indirect exposure to PB, which amounted to

approximately €139 million as of 31 March 2010[2]. The mission was disappointed that despite its repeated advice no action appears to have been taken to reduce the state's exposure to PB, which has in fact grown significantly since the matter was first discussed during July 2009 team visit. In parallel, the reduction of PB's insured deposits to approximately €18 million (an amount which could easily be repaid from the bank's cash on hand were it to be liquidated) makes it clear that PB no longer poses a systemic risk to the banking system but rather a significant fiscal risk.

11. ***Next steps***. Formulation of a clear strategy for the resolution of PB remains the critical remaining prior action for proceeding with potential FSDPL. The strategy should include credible, time-bound plan for: (i) addressing the likely capital deficiency, and (ii) reducing the bank's dependence on state deposits as liquidity support. Adoption of an acceptable resolution strategy by the CBCG and the Government would be necessary prior to presentation of the proposed FSDPL to the WB's Regional Operations Committee, and substantial progress with implementation of the strategy would be expected before the loan can be presented for approval to the WB's Board of Executive Directors.

12. The CBCG informed the mission that it intends to discuss a draft strategy for the resolution of PB at its next Council session. The Bank team stands ready to provide technical advice on this strategy and the CBCG has undertaken to provide a draft for comment before the strategy is finalized for presentation to the Council. Meantime, the mission would like to highlight three key factors that need to be taken into account in designing a resolution strategy for PB: (a) the current ownership structure of the bank represents an unacceptable reputational problem for the WB (and other multinational institutions) given the extent of PB's dependence on the state support; (b) any strategy must be designed to minimize the significant fiscal impact which would result if PB is unable to repay its direct and indirect borrowings from the state; and, (c) going forward PB's governance must be structured in a way which provides assurance that the bank's future operations will be managed in a transparent and prudent manner.

13. In view of the fiscal problem posed by the current large volume of state deposits in the bank, and given the bank's present shareholder structure, the mission would like to stress that any recapitalization by the current shareholders (or by parties which are related to the current shareholders) will need to be followed by full repayment of state deposits within the shortest possible timeframe. Given the numerous past violations of CBCG's directives and failure to fulfill the recapitalization commitments, current shareholders (excluding EPCG) should be given until no later than 30 June 2010 to recapitalize the bank. In is important to note that any participation in recapitalization by EPCG or any other state-majority owned or state-controlled enterprise should only be acceptable if it occurs in the context of a full nationalization scenario described below.

14. If recapitalization by existing private shareholders does not take place within the prescribed time-frame, the CBCG would need to intervene in the bank immediately and proceed, jointly with the MOF (as applicable), to implement a least-cost resolution strategy. Described below are three potential options for PB's resolution strategy which could be acceptable to the WB.

---

[2] These amounts include deposits in PB by the MOF, state controlled enterprises (including EPCG), state funds, municipalities, and subordinated debt purchased by EPCG.

i. Recapitalization by a reputable strategic investor.

PB would be placed by the CBCG in temporary administration for a short period (say a maximum of 45 days) during which a strategic investor would be sought. The capital of the bank would be written down and the shares of the current owners cancelled. If a reputable investor is found, it is likely that it would insist on the bank being brought to no less than zero capital prior to recapitalization, which would require conversion of a corresponding amount of state deposits into redeemable non-voting preferred shares. A repayment schedule (likely over 12 to 24 months) for the remaining balance of state deposits would be established by converting the state deposits to term deposits with corresponding maturities to the repayment schedule.

For the purposes of this strategy, the WB would need to review and be satisfied with documentation submitted to the CBCG in the course of qualifying a strategic investor as "fit and proper" to control a bank.

ii. Recapitalization by the state with the bank placed under independent governance until privatization.[3]

Either immediately upon appointment of a temporary administrator (if the probability of finding a reputable strategic investor is considered very low) or, following the 45 day period of temporary administration described above, the capital of the bank would be written down and the shares of the current owners cancelled. State deposits would be converted *pro rata* into two classes of non-voting preferred shares: (i) perpetual redeemable preferred shares in an amount equivalent to the negative capital of the bank, with a cumulating dividend preference at an agreed rate commencing five years from the date of sale of a majority of the voting common shares of the bank to a strategic investor (to provide an incentive for that investor to redeem them); and, (ii) convertible perpetual preferred shares, convertible at par to common shares on the date of sale of a majority of the voting common shares of the bank to a strategic investor, in an amount sufficient to increase the capital of the bank to a CAR reflecting the continuing risk of PB's operations.

Simultaneously with the conversion of state deposits to preferred shares, five voting common shares of [€1,000] nominal value would be issued as 100 percent of the common stock of the bank and purchased by the MOF. All voting rights for a period of three years attached to these shares would be irrevocably transferred to five independent persons (all of whom would have to be acceptable to the CBCG) under contracts which would require them to: (a) serve as the members of the supervisory board of PB; (b) use best efforts to repay state deposits and redeemable preferred shares, as prudent management of the liquidity of the bank permits; (c) appoint and oversee management and the development of the bank in accordance with prudent banking practices; and, (d) arrange the sale of the bank within three years to a reputable strategic investor acceptable to the CBCG.

[3] From the WB's perspective, conversion of further deposits of state and state-related entities into capital without the implementation of the governance measures described in this section would be unacceptable. The authorities are advised to draw on the positive experience with independent governance model used for Montenegro Banka.

In the event that a reputable private or multilateral investor (such as EBRD) agrees to participate in the recapitalization of PB as a minority investor, the WB would be prepared to discuss appropriate adjustments to the above-described structure.

iii. *Purchase and assumption of insured deposits followed by liquidation.*

In the absence of reputable strategic investor or recapitalization by the state, the CBCG will need to put PB into liquidation, and perform a purchase and assumption of insured deposits (and uninsured deposits, to the extent possible) to transfer them to another bank. The remaining state deposits will be repaid pro rata with other unsecured claims from the proceeds of liquidation. If this strategy is followed, the WB would need to review and accept the liquidation arrangements to ensure that transparent procedures are followed which ensure that claims against PB's debtors are fully enforced.