

## MONTENEGRO

## FINANCIAL SECTOR DEVELOPMENT POLICY LOAN

## AIDE-MÉMOIRE FOR PREPARATION MISSION

1. A World Bank mission<sup>1</sup> visited Montenegro between May 10<sup>th</sup> and 14, 2010, to continue the preparation of a Financial Sector Development Policy Loan (FSDPL), the first in the series of two planned programmatic loans. The team held meetings with officials of the Ministry of Finance (MoF), the Central Bank of Montenegro (CBCG), Deposit Protection Fund (DPF), donor community and commercial banks. The mission would like to thank the Montenegrin authorities for their hospitality and cooperation.
2. The team reviewed the progress made by the authorities with regards to implementation of prior policy actions for FSDPL, falling in the three general categories: (i) preparation and enactment of new financial sector legislation; (ii) implementation of supervisory strategies for systemic banks; and (iii) dealing with problem banks, with the focus on Prva Banka. The authorities confirmed that they remain interested in negotiating FSDPL by early fall, so that the loan can be disbursed by 4<sup>th</sup> quarter 2010. This Aide-Memoire summarizes the mission's findings and recommendations on what actions would be necessary in each policy area, in addition to the evidence of satisfactory macroeconomic framework, in order for the team to request the authorization from the WB's Regional Operations Committee to appraise and negotiate the loan, and then to present the loan for approval to the WB's Board of Directors.

## Financial Sector Laws

3. **Current status.** The authorities informed the mission that the package of five financial sector laws should be submitted to the Government for approval by the end of May, with the intention of securing enactment by Parliament by the end of June. Of the five laws, three most important ones (the amendments to the Law on Banks and the Bank Bankruptcy and Liquidation Law and the new Central Bank Law) have been agreed with the WB and IMF experts and are ready for further processing.
4. With respect to the remaining two laws, the mission would like to note the following:
  - While substantial work has already been done on the draft *Deposit Protection Fund Law*, the mission emphasized that the draft law requires further changes to enable the Deposit Protection Fund (DPF) to use its resources to support the purchase and assumption of insured deposits in cases where doing so would provide a lower cost resolution method than an insured deposit payout followed by liquidation. These changes are also necessary to make the new DPF law fully consistent with the proposed amendments to the Law on

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<sup>1</sup> The mission team included Mr. Alexander Pankov (Project Team Leader) and Mr. Andrew Lovegrove (Senior Banking Sector Expert). Mr. Lalit Raina, Sector Manager for Finance and Private Sector Development Unit in Europe and Central Asia Region and Ms. Irina Astrakhan, Country Sector Coordinator for Western Balkans, joined the key meetings.

Banks and the Bank Bankruptcy and Liquidation Law, which already envision the use of DPF resources for facilitating the purchase and assumption transactions.

In this context, the authorities expressed concerns – with which the mission concurs - that the DPF presently lacks the institutional capacity to execute more complex forms of deposit protection than payouts. The authorities also noted that KfW (which provided the seed capital for the DPF) needs to be consulted regarding more expansive powers for the DPF. The mission agreed to work with the authorities over the next several weeks to prepare the necessary amendments to the draft Deposit Protection Law. These amendments would give the required additional powers to the DPF, and allow a suitable transition period (one to two years) before becoming effective, to allow the DPF to build the necessary capacity. In the meantime, CBCG will retain main responsibility for resolution of failed banks.

- With respect to the draft *Financial Stability Council Law*, the authorities clarified that the objective of the Law is to formalize cooperation and coordination between financial sector regulators and the MOF. Based on experience from other countries, the mission suggested that this limited objective could be addressed – perhaps more easily – via a memorandum of understanding (MOU) between the MOF and the regulators rather than using the more rigid framework of a law. Should the authorities decide to proceed with a Law rather than an MOU, the mission emphasized that it is essential to ensure that the Law in no way impinges on the ability of CBCG to fully exercise its supervisory and regulatory functions in accordance with the new Central Bank Law. The mission understands that the authorities have requested the detailed comments on the draft Law from the IMF, which had already provided extensive comments on the draft CB Law.

5. **Next steps.** The mission noted that it would not be possible to present the proposed FSPDL to the WB's Regional Operations Committee until such a time as the agreed amendments to the Law on Banks and the Bank Bankruptcy and Liquidation Law and the new Central Bank Law have been submitted to Parliament. Enactment of respective laws in the form satisfactory to the WB would be a prior action required for submission of FSDPL for approval to the WB's Board of Directors. The mission also notes that full consistency needs to be ensured between (i) the draft DPF Law and the proposed amendments to the Law on Banks and the BBL Law regarding DPF's role in purchase and assumption transactions; (ii) the draft Financial Stability Council Law and the proposed new Central Bank Law.

### **Implementation of supervisory strategies for systemic banks**

6. **Current status.** On the basis of in-depth on-site examinations and stress-testing conducted in 4<sup>th</sup> quarter 2009, the CBCG has adopted the supervisory strategies for CKB, Hypo Alpe Adria Bank and NLB Montenegro (in addition to Prva Banka). The supervisory strategies for these systemic institutions call for capital injections in varying amounts to offset the worsening quality of credit portfolio. First round of capital injections has already been completed in the cases of Hypo (€17.5 million) and NLB Montenegro (€3 million). Hypo management advised the mission that its parent plans to inject a further €40 million during 2010 and CBCG informed the mission that NLB Montenegro intends to provide additional capital beyond the amounts required

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 2<sup>nd</sup> and 3<sup>rd</sup> 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<sup>2</sup>. 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. It 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.

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<sup>2</sup> 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.*<sup>3</sup>

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.

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<sup>3</sup> 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.