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PROJECT PERFORMANCE ASSESSMENT REPORT



MONTENEGRO  
**Financial Sector Policy-Based  
Guarantee**

**Report No. 106282**

JUNE 21, 2016

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**MONTENEGRO**

**FINANCIAL SECTOR POLICY-BASED  
GUARANTEE (P130157, IBRD: G2130)**

**June 21, 2016**

**IEG Human Development and Economic Management**  
*Independent Evaluation Group*

## Currency Equivalents (annual averages)

*Currency Unit = Euro (€)*

|      |          |       |
|------|----------|-------|
| 2012 | US\$1.00 | €0.77 |
| 2013 | US\$1.00 | €0.76 |
| 2014 | US\$1.00 | €0.73 |

## Abbreviations and Acronyms

|         |   |
|---------|---|
| DPO     | development policy operation                          |
| Euribor | Euro Interbank Offered Rate                           |
| FSAP    | Financial Stability Assessment Program                |
| FSC     | Financial Stability Council                           |
| FSDPL   | Financial Sector Development Policy Loan              |
| FSPBG   | Financial Sector Policy Based Guarantee               |
| GDP     | Gross Domestic Product                                |
| IBRD    | International Bank for Reconstruction and Development |
| ICR     | Implementation Completion and Results Report          |
| IEG     | Independent Evaluation Group                          |
| IMF     | International Monetary Fund                           |
| NCP     | National Contingency Plan                             |
| OPCS    | Operations Policy and Country Services                |
| PBG     | Policy-Based Guarantee                                |
| PPAR    | Project Performance Assessment Report                 |
| VAT     | Value Added Tax                                       |

## Fiscal Year

Government: January 1 – December 31

|   |                           |
|---|---------------------------|
| Director-General, Evaluation                            | : Ms. Caroline Heider     |
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| Manager, IEG Economic Management and Country Programs   | : Mr. Mark Sundberg       |
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This report was prepared by Aghassi Mkrtchyan, who assessed the project in October 2015. The report was peer reviewed by Shahrokh Fardoust and panel reviewed by Chad Leechor. Yezena Yimer provided administrative support.

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## Principal Ratings

|                                   | <b>ICR*</b>  | <b>ICR Review*</b>           | <b>PPAR</b>                  |
|-----------------------------------|--------------|------------------------------|------------------------------|
| Outcome                           | Satisfactory | Moderately<br>Unsatisfactory | Moderately<br>Unsatisfactory |
| Risk to<br>Development<br>Outcome | Substantial  | Significant                  | Significant                  |
| Bank Performance                  | Satisfactory | Moderately<br>Unsatisfactory | Moderately<br>Unsatisfactory |
| Borrower<br>Performance           | Satisfactory | Moderately<br>Unsatisfactory | Moderately<br>Unsatisfactory |

\* The Implementation Completion and Results Report (ICR) is a self-evaluation by the responsible Bank department. The ICR Review is an intermediate IEG product that seeks to independently verify the findings of the ICR.

## Key Staff Responsible

| <b>Project</b> | <b>Task Manager or<br/>Leader</b> | <b>Division Chief or<br/>Sector Director</b> | <b>Country Director</b> |
|----------------|-----------------------------------|--|-------------------------|
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| Completion     | Michael Edwards                   | Lalit Raina                                  | Ellen Goldstein         |



**IEG Mission: Improving World Bank Group development results through excellence in evaluation.**
**About this Report**

The Independent Evaluation Group (IEG) assesses the programs and activities of the World Bank for two purposes: first, to ensure the integrity of the Bank's self-evaluation process and to verify that the Bank's work is producing the expected results, and second, to help develop improved directions, policies, and procedures through the dissemination of lessons drawn from experience. As part of this work, IEG annually assesses 20–25 percent of the Bank's lending operations through fieldwork. In selecting operations for assessment, preference is given to those that are innovative, large, or complex; those that are relevant to upcoming studies or country evaluations; those for which Executive Directors or Bank management have requested assessments; and those that are likely to generate important lessons.

To prepare a Project Performance Assessment Report (PPAR), IEG staff examine project files and other documents, visit the borrowing country to discuss the operation with the government, and other in-country stakeholders, and interview Bank staff and other donor agency staff both at headquarters and in local offices as appropriate.

Each PPAR is subject to internal IEG peer review, Panel review, and management approval. Once cleared internally, the PPAR is commented on by the responsible Bank department. The PPAR is also sent to the borrower for review. IEG incorporates both Bank and borrower comments as appropriate, and the borrowers' comments are attached to the document that is sent to the Bank's Board of Executive Directors. After an assessment report has been sent to the Board, it is disclosed to the public.

**About the IEG Rating System for Public Sector Evaluations**

IEG's use of multiple evaluation methods offers both rigor and a necessary level of flexibility to adapt to lending instrument, project design, or sectoral approach. IEG evaluators all apply the same basic method to arrive at their project ratings. Following is the definition and rating scale used for each evaluation criterion (additional information is available on the IEG website: <http://worldbank.org/ieg>).

**Outcome:** The extent to which the operation's major relevant objectives were achieved, or are expected to be achieved, efficiently. The rating has three dimensions: relevance, efficacy, and efficiency. *Relevance* includes relevance of objectives and relevance of design. Relevance of objectives is the extent to which the project's objectives are consistent with the country's current development priorities and with current Bank country and sectoral assistance strategies and corporate goals (expressed in Poverty Reduction Strategy Papers, Country Assistance Strategies, Sector Strategy Papers, and Operational Policies). Relevance of design is the extent to which the project's design is consistent with the stated objectives. *Efficacy* is the extent to which the project's objectives were achieved, or are expected to be achieved, taking into account their relative importance. *Efficiency* is the extent to which the project achieved, or is expected to achieve, a return higher than the opportunity cost of capital and benefits at least cost compared to alternatives. The efficiency dimension generally is not applied to adjustment operations. *Possible ratings for Outcome:* Highly Satisfactory, Satisfactory, Moderately Satisfactory, Moderately Unsatisfactory, Unsatisfactory, Highly Unsatisfactory.

**Risk to Development Outcome:** The risk, at the time of evaluation, that development outcomes (or expected outcomes) will not be maintained (or realized). *Possible ratings for Risk to Development Outcome:* High, Significant, Moderate, Negligible to Low, Not Evaluable.

**Bank Performance:** The extent to which services provided by the Bank ensured quality at entry of the operation and supported effective implementation through appropriate supervision (including ensuring adequate transition arrangements for regular operation of supported activities after loan/credit closing, toward the achievement of development outcomes. The rating has two dimensions: quality at entry and quality of supervision. *Possible ratings for Bank Performance:* Highly Satisfactory, Satisfactory, Moderately Satisfactory, Moderately Unsatisfactory, Unsatisfactory, Highly Unsatisfactory.

**Borrower Performance:** The extent to which the borrower (including the government and implementing agency or agencies) ensured quality of preparation and implementation, and complied with covenants and agreements, toward the achievement of development outcomes. The rating has two dimensions: government performance and implementing agency(ies) performance. *Possible ratings for Borrower Performance:* Highly Satisfactory, Satisfactory, Moderately Satisfactory, Moderately Unsatisfactory, Unsatisfactory, Highly Unsatisfactory.

## **Preface**

This is the Project Performance Assessment Report (PPAR) of the Montenegro financial sector policy-based guarantee implemented in 2012–2013. The Independent Evaluation Group (IEG) prepared the report. It is based on interviews, documents, and data collected during a mission to Montenegro in November 2015, during which government officials, external development partners, and business groups, academics, nongovernmental organizations, civil society groups, and other stakeholders were consulted. The evaluation also draws on in-depth interviews of World Bank and International Monetary Fund staff, including current and former members of the Montenegro country teams in Washington, D.C., and Podgorica; and on published and internal documents from the two institutions. The cooperation and assistance of all stakeholders and government officials are gratefully acknowledged as is the support of the World Bank office in Podgorica.

Following standard Independent Evaluation Group (IEG) procedures, a copy of the draft report will be circulated in parallel to the relevant government officials and agencies for their review and feedback. Comments were received and are attached as Appendix D.



## Summary

This Program Performance Assessment Report (PPAR) evaluates the financial sector policy-based guarantee (FSPBG) to Montenegro in the amount of €60 million implemented in 2012–2013. It supported a commercial loan in the amount of €100 million. The FSPBG was prepared by converting the second operation of the programmatic series of financial sector development policy loan (FSDPL) in the amount of USD\$20 million into a guarantee instrument to respond to the large external financing needs of Montenegro.

PPAR reviews the performance of this operation based on both IEG and Operations Policy and Country Services (OPCS) guidelines. The report makes use of program level evidence and draws broader lessons on the use of policy-based guarantees in the Bank.

The FSPBG had one objective: strengthening the banking system. The objective was substantially relevant to World Bank (henceforth “the Bank”) and Government strategies and to country conditions both at the time of entry and closing. Design of the program, however, had shortcomings and was assessed as modest because of the lack of operational focus on the program’s macroeconomic framework as well as risks and shortcomings in assessing Montenegro’s eligibility for a policy-based guarantee (PBG).

The achievement of the objective was modest. The banking system largely recovered from the crisis. Market confidence was restored, and total deposits surpassed the pre-crisis level, while more banks entered Montenegro’s market following the operation. The reform program, however, remains incomplete. Gaps exist in crisis management, while banking supervision is not fully in compliance with the Basel Core Principles for Effective Banking Supervision. The decline in nonperforming loans was slower than expected, and further reform efforts are required to improve transparency. Withdrawal of public sector deposits in Prva Banka to ensure market-based funding was reversed in 2014 and 2015. The bank continued to hold a large amount of public sector deposits at the time of the evaluation. This evaluation highlights that many important outcomes that were achieved in the banking system of Montenegro were attributable to the strong reform actions supported by the predecessor program—FSDPL, underscoring the relatively low value added of the FSPBG.

The overall outcome is rated moderately unsatisfactory.<sup>1</sup> The operation’s objective was substantially relevant, but the design was modest. The outcome rating reflects IEG’s assessment about the inadequacy of the PBG as an engagement modality, lack of Bank’s focus on macroeconomic framework and risks, an incomplete banking system reform agenda.

The risk to development outcomes is rated significant because of the limited decline in nonperforming loans in the banking system, incomplete reform agenda in reporting and quality of asset review, and the overall macro and fiscal risks. The Bank’s performance is rated moderately unsatisfactory, reflecting weaknesses in quality at entry related largely

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<sup>1</sup> The outcome rating is assessed on a six-point scale: Highly Satisfactory, Satisfactory, Moderately Satisfactory, Moderately Unsatisfactory, and Unsatisfactory (IEG and OPCS guideline).

to the choice of the instrument. Borrower performance is rated moderately unsatisfactory because of continued funding of Prva Banka through deposits of public agencies and fiscal policy choices that heightened the risks to economic stability.

**Among the key lessons are:**

- PBGs can potentially be a useful instrument for supporting countries facing large external financing needs.
- PBGs implemented in a context of challenging macro-fiscal situation and large financing needs need to incorporate a consistent macro-economic framework with necessary macro and fiscal actions for risk mitigation.
- The choice of a PBG as an instrument should be based on robust macro and fiscal projections indicating that financing framework is sustainable and macro risks are mitigated. Montenegro's case indicates that eligibility for a PBG cannot be decided based on general announcements by the government that lack details. The case highlights once again the criticality of Bank-Fund cooperation.
- Comparing the aggregate interest rate of PBG-supported debt instruments with counterfactual market rates may not be enough for assessing the extent of reduction in the borrowing costs associated with the transaction. Estimating the change in sovereign risk perceptions, although a challenging task, may give more accurate assessment of the impact of the program.

Nick York  
Director  
Human Development and Economic Management  
Independent Evaluation Group

# 1. Background and Context

1.1 Montenegro is a small economy in the Western Balkans with a population of 700,000, and per capita income of around USD\$7,100 in nominal terms in 2013. It experienced one of the most severe boom and bust cycles in late 2000s that left its banking system extremely fragile and in a need of restructuring. The economy contracted by about 6 percent in 2009 following rapid growth in high single digits fueled by external capital inflows and domestic credit. Notwithstanding a brief recession in 2012 within in the Eurozone, the economy has been recovering since 2010.

1.2 The Montenegrin banking system, which is dominated by foreign-controlled banks, witnessed massive deposit withdrawals and rapid deterioration in asset quality in 2008–2009 that led to a severe shortage of capital. Prva Banka, the largest domestic bank and the second largest bank in the system at the time, was hit hardest and given emergency support. The situation improved in 2010–2011 through management of nonperforming loans (NPLs), restructuring of Prva Banka, and capital injections from foreign banks to their Montenegrin subsidiaries. Reforms were supported by the World Bank through technical assistance and a financial sector development policy operation (DPO)—the Programmatic series of financial sector development policy loan (FSDPL), which was launched in 2011.

1.3 The program under review was prepared against the background of renewed economic and fiscal tensions in early 2012. Authorities were facing a large financing gap from the second round of recession in the context of large debt repayments. Borrowing space had been substantially narrowed by expansionary policies in 2008–2011 and large contingent liabilities resulting from state guaranties provided to the metal industries, some of which were called. The government introduced a package of revenue and expenditure measures for fiscal consolidation and announced new and ambitious fiscal and debt targets. However, they were not sufficient to secure a program with the International Monetary Fund (IMF) because of the lack of specific, medium-term spending and revenue measures. Areas of particular concern included large public sector wages, entitlement spending programs especially pensions, and low revenues from the value added tax (VAT) largely from the low tax rate.

1.4 Montenegro resorted to commercial loans from international banks to cover the financing gap estimated for 2012 at 9–10 percent of gross domestic product (GDP). A loan negotiated with Credit Suisse in April 2012 in an equivalent of 5 percent of GDP was partially supported by gold collateral but had a high interest rate—6.5 percent premium over the Euribor’s 12-months rate). To respond to Montenegro's large financing requirement, the Bank converted the second operation of FSDPL under preparation with an envisaged amount of €20 million into a €60 million policy-based guarantee (PBG). In doing so, the Bank used the policy actions implemented as triggers for the second FSDPL and focused on systemic risks monitoring, crisis preparedness, restructuring of Prva Banka, and strengthening of bank supervision as prior actions for the operation. The PBG allowed the government to mobilize €100 million, or 3 percent of GDP, in budget financing with a lower interest rate of Euribor 12 months plus 3.5 percent. This was the third PBG prepared in the region, following similar operations in both the former Yugoslav Republic of Macedonia and Serbia in 2011.

1.5 The World Bank's self-evaluation of the PBG through the Implementation Completion and Results Report assigned a "satisfactory" outcome rating to the operation resulting from substantial achievements in banking sector reforms. This PPAR is one in a series of four project-level evaluations covering PBGs implemented in the Western Balkans in 2011–2013 to assess the extent and sustainability of results and derive lessons about the instrument's use.

## 2. Objectives

2.1 The program document states that the overarching goal of the program was to strengthen the banking sector, a critical precondition for sustainable economic recovery and balanced private sector-led growth.<sup>2</sup> IEG is using this stated objective for the purpose of its evaluation.

## 3. Relevance of Objectives—Substantial<sup>3</sup>

3.1 The stated objective was relevant to country context and the World Bank's strategic priorities outlined in the country partnership strategy (CPS) for 2011–2014 (World Bank 2010). The CPS had a specific outcome on "a stronger banking system governed by a modern regulatory framework and central institutions, which is more resilient to future shock" under the pillar of "Support EU accession through strengthening institutions and competitiveness." The objective came from the discontinued FSDPL and was strongly relevant to the context. Montenegro's boom and bust cycle left its banking sector exposed to major risks. Banks experienced massive deposit withdrawal and rapid deterioration in their assets quality during 2008–2009, resulting in a severe shortage of capital. Prva Banka, the largest domestic bank, was hit hardest and given emergency support. The situation improved in 2010–2011 through management of nonperforming loans (NPL), restructuring of Prva Banka, and capital injections from foreign banks to their Montenegrin subsidiaries. At program preparation in the first half of 2012, the reforms to strengthen the banking system were still underway, while systemic risks were still present because of a volatile external environment and bad asset quality of the banks.

3.2 The areas targeted by the operation, including monitoring systemic risks, restructuring the Prva Bank, addressing NPL, and strengthening deposit protection and the regulatory framework were relevant given the challenges facing the country. This objective remained relevant during the program's implementation and aftermath periods based on the importance of a well-functioning banking system for economic growth and the need to reduce contingency liability risks for the state from possible destabilization in the financial sector.

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<sup>2</sup> Program Document, Guarantee and Program summary, page v.

<sup>3</sup> The relevance of objectives and design is assessed by IEG based on four-scale criteria that includes High, Substantial, Modest, and Negligible.

## 4. Relevance of Design—Modest

4.1 The relevance of design is assessed as modest based on IEG's assessment of the instrument choice, the program's macroeconomic and fiscal framework, and the program's policy content. Strengths included the relevance and institutional depth of most prior actions and their importance for achieving the stated objective. The evaluation, however, finds that Bank's analysis of Montenegro's compliance with the criteria for a PBG was based on controversial assumptions about fiscal consolidation in the short term. These assumptions did not come from a credible analysis of the country's fiscal policy stance, and, in this respect, were not fully justified. In addition, major macro and fiscal risks warranted the mitigating of measures in the program, but they were not addressed. The risks could have been addressed only through an operational focus on the macroeconomic framework supported by necessary actions and monitorable indicators.

### Macroeconomic Framework and Risks

4.2 After a fragile recovery in 2010–2011, the country was hit by a new recession in 2012 from volatility in the external environment. Policy response was constrained by elevated public and publicly guaranteed debt that had increased from about 30 percent in 2008 to 57 percent in 2011. Materialization of major contingency claims, such as the calling of guarantees issued by the state for metallurgic companies, in the amount of 4–5 percent of GDP further reduced the policy space. In addition, repayments of external debt scheduled for 2012 were quite large, which increased the country's financing gap further.

4.3 In February 2012, the government introduced a package of medium-term revenue and expenditure measures for fiscal consolidation. It also announced ambitious medium- and long-term fiscal targets. They included reducing budget expenditures to 38 and 35 percent of GDP by 2015 and 2018, respectively, from 43 percent in 2011 and reducing public debt to 48 and 35 percent of GDP by 2015 and 2018, respectively, from 57 percent in 2011. Specific and detailed spending adjustment plans were absent. The financing gap for 2012, however, remained at an estimated €230 million to €250 million (7 to 8 percent of GDP), which the authorities were planning to cover through commercial loans.

4.4 At the same time, the authorities were also discussing a possible program with the IMF. It did not materialize because the fiscal consolidation measures were not sufficient to contain a sharp increase in public debt. The IMF found that the announced medium- and long-term fiscal plans lacked credibility and were inconsistent with the existing spending programs. Areas of particular concern included large public sector wages, entitlement spending especially pensions, and the low VAT tax rate.

4.5 To secure financing, the authorities borrowed €150 million from Credit Suisse in April 2012 with a 6.5 percent premium over the Euribor's 12-months rate and a maturity of five years. The interest rate was quite high despite the use of gold as collateral to cover 30 percent of the loan.

4.6 Against this background, the World Bank made a decision to convert the second operation of FSDPL in an envisaged amount of €20 million (0.7 percent of GDP in 2012)



into a guarantee of €60 million, or 2 percent of GDP, to support a commercial loan in the amount of €100 million, or 3 percent of GDP. By doing this, the Bank effectively provided an exceptionally large balance of payment and budget support in a risky macroeconomic environment, which made the program strongly macro relevant. The commercial loan supported by the guarantee was finalized in July 2012 and had an interest rate of Euribor 12 months plus 3.5 percent.

4.7 The FSDPL that was converted into the PBG was intended to strengthen the banking system and maintain an adequate macroeconomic framework.<sup>4</sup> The macro objective was effectively dropped during the conversion of the DPO into a much larger PBG operation and macro and fiscal challenges were not reflected in the program's objective despite intensified macroeconomic concerns during 2012. A strong need existed for recalibrating policy to address growing risks. A few months after the approval of the guarantee, the World Bank began preparation of a new DPO with a fiscal consolidation objective. It did not materialize because the authorities did not implement the necessary actions for fiscal consolidation.

4.8 The importance of addressing of macro and fiscal challenges that Montenegro faced is highlighted in the 2011–2014 CPS. It mentioned that the use of DPOs in a deteriorated fiscal climate might be warranted to help reestablish growth and fiscal health.<sup>5</sup> The CPS also highlighted that the planned programmatic series of FSDPLs, the second operation of which was converted into the FSPBG, would support the government's aims to maintain a stable macroeconomic framework over the short to medium term, including sustainable deficit and debt levels.<sup>6</sup> One of the CPS outcomes was to improve public expenditure management as indicated by decreases in the target deficit and debt levels.

4.9 The evaluation finds the decision to provide a very large financing in an environment of major macroeconomic risks without a macro and fiscal objective was a design weakness. While strengthening the banking system was important for maintaining macro stability and fiscal sustainability, other significant risks associated with policy choices could have undermined the soundness of the macro framework. The fact that the public debt rose sharply after program implementation confirms that the risks at program preparation were significant. Mitigating measures in the policy contents in the operation were much needed. For illustration, in 2015, public expenditures were around 48 percent of GDP instead of 38 percent as targeted by the government in 2012. The public debt to GDP ratio was at 66 percent in 2015 versus 48 percent as announced by the government in 2012, while public and publicly guaranteed debt was close to 80 percent of GDP.

## Choice of Instrument

4.10 As the country's financing needs were sizeable, the choice of the instrument allowed the Bank to provide financing to Montenegro beyond a typical DPO and without exceeding country exposure limits set by the International Bank for Reconstruction and Development

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<sup>4</sup> FSDPL1 Loan agreement, page 12.

<sup>5</sup> page 62 of the 2011-2014 CPS.

<sup>6</sup> page 27 of the 2011-2014 CPS.

(IBRD).<sup>7</sup> This evaluation finds that the World Bank's strategic consideration to substantially cover Montenegro's 2012 financing needs was the key motivation behind the choice. The use of the instrument could have helped to reduce the borrowing costs.

4.11 Montenegro's eligibility for PBG on macro, debt, and financing at the time of program preparation was assessed on the basis of external and public debt projections presented in the program document.<sup>8</sup> These calculations assumed a declining path for public and external debt starting 2012 and a return to more sustainable debt level by 2015 (49 and 92 percent of GDP, respectively). The evaluation finds that the projections deviated substantially from IMF's projections prepared in April for the 2011 Article IV and available for the Bank before the operation's appraisal. The IMF expected a steep upward trajectory for public and external debt because of the lack of credible measures for fiscal consolidation. The Bank, in contrast, used the authorities' optimistic announcements on aggregate fiscal parameters as a basis for assessing Montenegro's eligibility for a PBG. Figures 4.1 and 4.2 indicate the scope of divergence between projections as well as actual developments in 2012–2014.

4.12 The evaluation finds an optimistic bias in the World Bank's projections of the debt parameters underpinning the assessment of the borrower's compliance with PBG eligibility criteria. The government's assurances on reversal of the trend in debt accumulation presented in the letter of development policy were not supported by concrete fiscal measures. They contrasted with IMF's assessment that both external debt and public debt would continue to grow in the absence of a credible fiscal consolidation plan.

4.13 The guarantee's program document does not discuss IMF's projections nor provide explanations on the divergence in debt and fiscal projections<sup>9</sup>. As public and external debt projections were critical in determining eligibility for a PBG according to the operational framework governing the instrument at the time,<sup>10</sup> the evaluation finds that the eligibility assessment could have reached a different conclusion if the Bank had used the IMF's more realistic projections.

4.14 The guarantee supported a €100 million commercial loan from Credit Suisse with an interest rate of Euribor12 months plus 3.5 percent. The interest on the loan, at face value, was substantially lower than the €150 million loan from Credit Suisse with partial collateral contracted in April 2012. However, comparing the aggregate interest rate of PBG-supported financial instrument with market rates available to the borrower may not be enough for assessing the extent of reduction in the borrowing costs associated with the guarantee transaction as the interest rate of the guaranteed instrument by definition should be lower than the rates of "clean" instruments without guarantees. A more comprehensive approach would be to assess the change in market's perceptions of sovereign risk as a result of the

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<sup>7</sup> The World Bank has a 1:4 rule for PBG (Policy Based Guarantee) whereby USD\$4 of commitment in guarantees count as USD\$1 of country exposure.

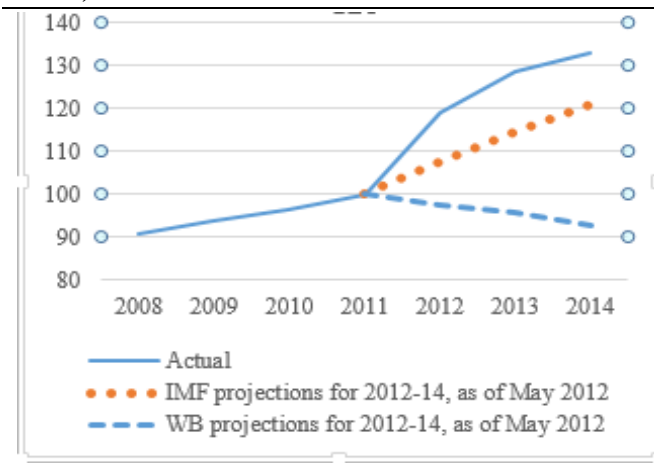
<sup>8</sup> Tables 4 and 5 of PD, pages 14 and 16.

<sup>9</sup> Program Document of the PBG under review.

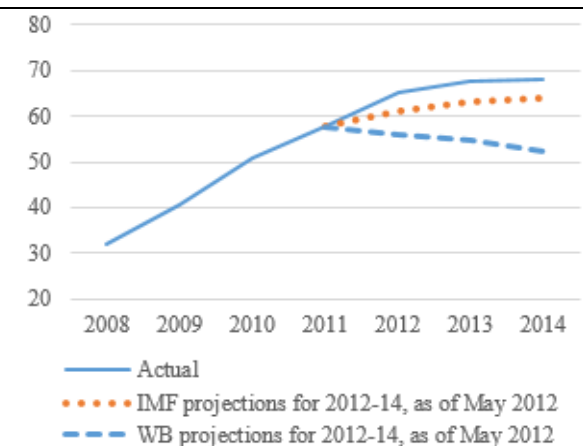
<sup>10</sup> The operational framework for the Bank's policy-based guarantees was merged into the framework of development policy operations in 2014.

underlying macroeconomic and structural policy program supported by Bank's policy lending. This could be done by estimating the implicit interest rate on non-guaranteed component of the loan by isolating non-sovereign risk factors associated with the transaction (IBRD risk, liquidity premium, etc). Although IEG does not look at these aspects for performance evaluation purposes, this evaluation highlights the importance of developing an approach to comprehensively assess the impact of PBGs on client's borrowing terms.<sup>11</sup>

**Figure 4.1. Actual, World Bank, and IMF External Projections for 2012–2014, as of May 2012, % in GDP**



**Figure 4.2. Actual, World Bank, and IMF Public Debt Projections for 2012–2014, as of May 2012, % in GDP**



Source: IMF and World Bank.

Note: GDP = gross domestic product; IMF = International Monetary Fund.

## Policy Content and Results Framework Analysis

4.15 Analysis of the program's policy content and results framework focuses on the links between objectives, outcomes, and policy actions; the relevance and quality of policy actions; and the choice of result indicators. There were strong links between prior actions, outcomes, and objectives and satisfactory institutional depth and criticality of most prior actions. The program included important actions for cementing the reforms under the first operation of FSDPL, such as satisfactory progress with Prva Banka's restructuring, the maintenance of periodic systemic risk monitoring, and further strengthening of regulations on deposit insurance and various bank regulations by the Central Bank. Most of the results indicators were adequate in measuring the outcomes pursued by the program.

4.16 The guarantee's policy matrix mimicked the planned second operation of FSDPL, which was converted into the program under review. According to the original design of FSDPL, most critical actions were planned and implemented under the first operation, while the triggers for the second operation were less critical. The fact that under the first operation the Bank disbursed €60 million while it was planning to disburse only €20 million under the

<sup>11</sup> The World Bank has not yet developed an approach for such an assessment in spite of scaling-up of PBGs since 2011. IEG will look at this and other important aspects of PBGs as part of a learning product on PBGs that will draw on this and other PPARs.

second confirms that the policy content of the programmatic loan was substantially frontloaded. This evaluation finds that the conversion of the second operation with relatively less critical policy actions into a guarantee without strengthening the policy matrix was a lost opportunity given the slow pace of reform implementation in some areas at the time of program preparation.

## **5. Implementation**

5.1 The PBG was converted from the envisaged second operation of FSDPL and, as such, it utilized the implementation mechanisms that were in place for the first operation of FSDPL. Therefore, both the Bank team and government counterparts had previous experience in dealing with various aspects of World Bank programs, including working on the policy matrix and monitoring the results. The Bank's experience with PBGs in the region was utilized during program implementation. Preparation and implementation of the operation also required strong cooperation among various units of the Bank, including the core PBG team, the Bank's lead network—FPD (Finance and Private Sector Development network), PRM (Poverty Reduction and Economic Management network), treasury, FINCR, and the country team. The Ministry of Finance, as the implementing agency, played a coordinating role. The Central Bank of Montenegro was closely involved.

5.2 The operation triggered no safeguards. No specific Poverty and Social Impact Analysis was conducted for the operation, although the team provided an adequate assessment of possible adverse social and distributional effects of the policies it supported.

## **6. Achievement of Objectives: Strengthening the Banking System—Modest**

6.1 IEG assessed the objective's achievement based on outcomes outlined in the program. On balance, its achievement was modest. The banking system recovered from the crisis, and the number of banks increased due to the renewed interest of foreign investors in Montenegro's financial system. Market confidence has been restored, and total deposits have surpassed the pre-crisis level. The Banks' capital adequacy remained strong, but nonperforming loans were brought down only to a limited extent. They still represent a major problem constraining credit growth. Prva Banka was substantially downsized, but the government's deposits still represented a significant portion of its total deposits at the end of 2015. The decline in the share of deposits of public agencies in Prva Bank's funding base that was observed in 2011–2013 proved to be temporary. The Financial Stability Assessment Program (FSAP) highlighted gaps in crisis management and compliance with the Basel Core Principles for Effective Banking Supervision. In addition, some outcomes in the banking system were attributable to the policy actions supported by FSDPL, underscoring limited value added of the FSPBG.

## **Outcome 1: Strengthening Systemic Risk Monitoring and the Crisis Management Framework—Partially Achieved**

6.2 This was one of the primary areas of the program's focus. Strengthening of the Central Bank's capacities for crisis response and establishment of the Financial Stability Council (FSC) through new laws introduced in 2010 were important stepping-stones in strengthening Montenegro's crisis preparedness. Development of the institutional framework for risk monitoring and crisis management occurred in 2011 and 2012 with regular quarterly meetings of the FSC.

6.3 The program's focus was on developing systemic risk assessment methodology and contingency crisis plans including draft legislation that would grant extraordinary powers to the Central Bank and the government to provide emergency liquidity and capital during a declared financial crisis (a prior action). The program also included more institutionalization of the risk-monitoring framework by supporting FSC's periodic monitoring and macroprudential decisions (a prior action). As a result of these actions, the macroprudential oversight and crisis management framework were expected to be enhanced in line with international good practice, as appraised by the next financial FSAP update.

6.4 In addition to the FSAP, the evaluation draws on interviews with stakeholders, including the Central Bank and IMF. The FSC has continued to meet regularly, which has helped to sharpen the focus of the authorities on important financial sector issues. The FSC has adopted the National Contingency Plan (NCP) to complement institution-specific contingency plans. However, the FSAP highlights that the FSC does not always focus on crisis preparedness and its management mandate. The key focus has been on its systemic risk-monitoring mandate, while the progress toward the NCP's implementation is rarely discussed by the FSC. A system-wide crisis simulation exercise involving all FSC members and the Deposit Protection Fund has not been conducted yet. According to the FSAP, none of the oversight agencies have formal cross-border arrangements with home resolution authorities, nor is a cross-border crisis management framework in place. In general, the 2016 FSAP assessed actions by the authorities toward establishing a systemic crisis management framework and a strategy for emergency liquidity provision as only partly implemented.

## **Outcome 2: Addressing Banking Sector Vulnerabilities—Partially Achieved**

6.5 Under FSDPL, the World Bank helped the authorities supervise major banks and develop supervisory action plans for troubled banks. Under FSPBG, these activities were continued, and the supervisory plans were updated for 2012 based on the results of on-site examinations, off-site monitoring, and stress-test results (a prior action). An improvement was expected in the asset quality as evidenced by a decline in the ratio of NPLs from 20 percent in 2011 to 12 percent by the end of 2013. It was also expected that the capital adequacy ratio of the banking system would remain at 15 percent or higher.

6.6 The Central Bank continued undertaking annual exercises to prepare and execute supervisory action plans in selected banks after the program's end. Improved regulatory oversight, tightened credit practices, and positive growth in the economy have contributed to

an improvement in the asset quality of the banks. However, NPLs have declined less than expected. At the end of 2015, they were at about 14.5 percent<sup>12</sup> instead of 12 percent as targeted by the program. Although the ratio of NPL declined substantially since their peak level of 25 percent in mid-2011, the decline largely took place in 2011 and 2012. In that period, the ratio of NPL was brought down to less than 18 percent through policy actions undertaken by the Central Bank with the support of FSDPL.<sup>13</sup>

6.7 The limited decline in NPLs is partly explained by slow implementation of restructuring based on voluntary debt repayment (the “Podgorica approach”) and a temporary increase in NPL that took place as a result of the second recession in 2012. The law supporting the voluntary debt repayment mechanism was approved in April 2015 and provided tax incentives for participants. It primarily targets firms that are facing temporary problems with debt repayment rather than solvency issues—it would not be a solution for all NPLs. The banks transferred about €600 million of their assets to factoring companies in 2011–2012 that substantially helped to reduce the ratio of bad loans. The lack of transparency and oversight of factoring companies, however, creates additional risks for the financial system.

6.8 The ratio of NPL varies from 9 to 23 percent across individual banks, indicating variability in the banks’ asset quality. The construction sector, which went through a boom and bust cycle, remains a major source of NPLs. The banks that are more exposed to the sector have a higher NPL ratio. Some observers noted that because of shortcomings in asset quality reviews, the actual extent of poor quality assets might be somewhat bigger than official data show.

6.9 The capital adequacy ratio, an outcome indicator for the program, was about 15 percent at the end of 2015, in line with the target value. This is a substantial improvement compared to 12 percent in 2011. However, as with the decline in the share of NPL, this improvement largely took place in 2011 and 2012 with the support of the FSDPL. This underscores relatively little value added of the FSPBG in reducing banking system vulnerabilities.

6.10 All banks were in compliance with the capital requirement provision. Entry of three foreign banks in 2014–2015 strengthened the overall capital adequacy of the banking system. Returns to assets, which were negative in 2008–2012, turned positive in 2013 and remained so although still quite modest (0.27 percent as of Q3 of 2015). Although the average interest rate of new loans was reduced from 10.8 percent in 2014 to 9.6 percent in 2015, the spreads remain quite large, at around 7.5 percent.

### **Outcome 3: Restructuring Prva Banka—Partially Achieved**

6.11 Prva Banka was the largest domestically owned bank and of systemic importance before the crisis. The Bank suffered substantial shortage in capital and a loss in confidence resulting in a very large deposit outflow. It was the only bank for which emergency support

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<sup>12</sup> IMF Article IV, March 2016

<sup>13</sup> IEG review of FSDPL’s Implementation Completion and Results Report.

was needed. After stabilization, the authorities focused on restructuring and downsizing the bank. The Central Bank developed a supervisory action plan whereby the central government was expected to gradually remove its deposits from Prva Banka and maintain a capital adequacy ratio of at least 12 percent (prior actions).

6.12 Prva Banka was considerably downsized in 2011–2012, becoming an average-sized market player. In 2013–2015, there was no substantial increase in its assets and portfolio, and the bank was in compliance with the Central Bank’s regulatory provisions. According to the authorities, the bank does not have strategic ambitions to recapture its previous market share. However, a reversal occurred in the positive trend of withdrawal of government deposits from the bank. While government deposits dropped to €700,000 by 2013, this was reversed in 2014. Deposits grew to €4 million in 2014 and to €19 million in 2015, which is around 7.5 percent of all deposits. For comparison, the government’s deposits before the program were €18 million. The evaluation finds that although Prva Banka has become smaller and no longer represents a source of financial sector instability, the authorities were not able to ensure fully market base financing for the Bank.

#### **Outcome 4: Enhancing the Depositor Protection Scheme—Achieved**

6.13 The operation was focused on improving the standards of communication of the Deposit Protection Fund (DPF) and developing detailed regulatory framework for deposit insurance, including the coverage and payment mechanisms of guaranteed deposit payouts (prior actions). These actions were based on important measures supported by the first operation of the programmatic loan, including enactment of the Law on Protection of Deposits, to develop a mechanism for ensuring a smooth transition from the blanket deposit guarantee and enhance the financial resources of the DPF by allowing additional funding sources in an emergency. It was expected that strengthening of the deposit protection scheme would further contribute to market confidence in the banking system as measured by positive growth in deposits and their return to a previous level.

6.14 A major recovery occurred in banking sector deposits, an outcome indicator monitored for the program. By the end of 2013, total deposits reached €2.1 billion. By the end of 2015, they stood at €2.6 billion, substantially higher than before the crisis. The number of banks totaled 14 at the end of 2015, reflecting the entry of more banks. The authorities have encouraged the entry of new banks to increase competition and reduce the interest spread, which stood at 7.5 percent at the end of 2015.

#### **Outcome 5: Improving the Regulatory Framework for Banks—Partially Achieved**

6.15 The focus here was to further implement the Standardized Basel II Approach by adopting regulations on capital adequacy, the calculation of bank exposures, public disclosure of information and data by banks, and on minimum standards for credit risk to implement international financial reporting standards for the banking system (prior actions). To improve the legislative framework for collateral and facilitate enhanced liquidity management at financial institutions, the program also supported approval of the draft law on financial collateral as a prior action. As a result of these measures, all banks were expected to

produce financial statements in line with international accounting standards as of 2014 (an outcome indicator) and the supervision of the banking system would be fully in line with Basel Core Principles (an outcome indicator). Adequate liquidity in the banking system also was expected (an outcome indicator).

6.16 Available information at the time of the evaluation indicates that the Central Bank has adopted key prudential measures, and the regulatory framework has been improved. All banks were in compliance with IFRS standards in 2015. The liquidity ratio in the banking system has been satisfactory, fluctuating between 26 and 32 percent in 2013–2015. At the end of 2015, liquidity was 28.5 percent. The Law on Financial Collateral was approved by parliament and enacted in August 2012.

6.17 With respect to the compliance with the Basel Core Principles, the FSAP highlights some major gaps. The implementation of the Central Bank’s prudential limits for related-party transactions and large exposures remains weak. The Central Bank’s measurement of exposures is not fully in line with Basel norms. The aggregate limit for all related-party exposures is 200 percent of own funds, which is too high compared to 25 percent under the Basel Core Principles. There are also significant gaps in the definitions of “related party” and “related-party transactions.” Addressing concentration risks, including sector concentration and concentration through collateral, remains weak.

## **Outcome 6: Macroeconomic Developments in 2012–2015—Not Rated**

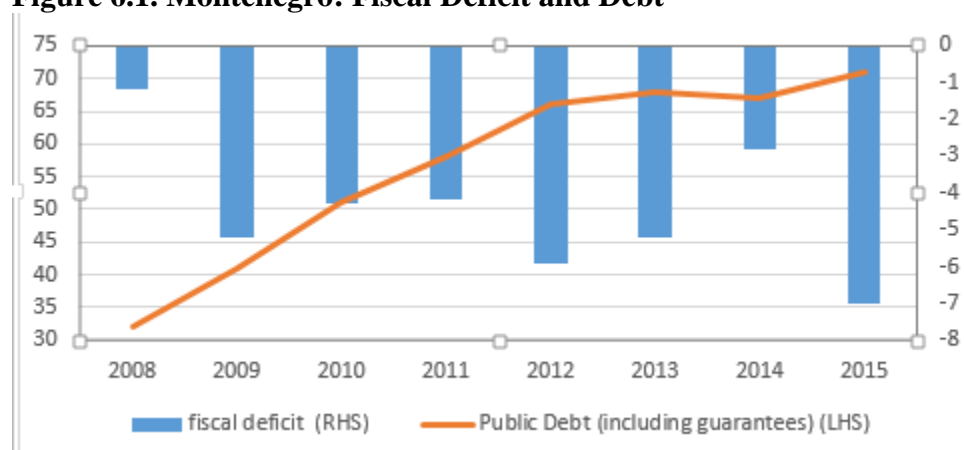
6.18 With respect to overall economic performance, growth has been volatile since 2012. The recession of 2.5 percent in 2012 was followed by a recovery in 2013 of 3.3 percent, which slowed to below 2 percent in 2014. Implementation of large capital expenditures as well as a more favorable external environment have pushed growth to an estimated 4 percent in 2015, where it is expected to remain in the medium term given large public investment projects. The largest project, the highway connecting the country’s major port to the border with Serbia, will be implemented in next few years and will cost more than 20 percent of the 2014 GDP.

6.19 Budget deficits during 2013–2015 reflected large capital expenditures (figure 6.1). The key concern is that the government did not prioritize its spending programs to create fiscal space for a strategic highway project. Its implementation will further elevate the debt to GDP ratio to about 80 percent by 2018. The extent of economic and financial returns from the project and, respectively, the capacity to repay the debt in a fiscally neutral manner, remain uncertain. If assumptions on expected highway traffic and revenues do not materialize, the project will pose major long-term risk to fiscal sustainability. The launch of the highway project in 2014 was the key reason behind the downgrade of Montenegro’s credit rating by Standard & Poor’s in 2014.<sup>14</sup>

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<sup>14</sup> For more information visit <http://wire.seenews.com/news/s-p-cuts-montenegro-long-term-rating-to-b-affirms-short-term-rating-at-bb-outlook-positive-448860>.



**Figure 6.1. Montenegro: Fiscal Deficit and Debt**

Source: IMF.

Note: LHS = left hand side; RHS = right hand side.

6.20 With respect to the overall fiscal stance, the government announced in 2015 its intention of implementing fiscal consolidation in the medium term. This evaluation finds that under current circumstances and in the absence of a strong fiscal responsibility framework,<sup>15</sup> fiscal consolidation will be difficult to achieve.

## 7. Outcome Ratings

7.1 The overall outcome rating is moderately unsatisfactory. It reflects substantial relevance of the objective and modest relevance of design as well as modest achievements in the objective to strengthen the banking system. Notwithstanding important steps taken to strengthen the banking system of Montenegro, some of the important outcomes in reducing banking system vulnerabilities are attributable to the initial reforms in 2010 and 2011 supported by FSDPL. The overall reform agenda, at the same time, remains incomplete. The quality of the banking system's assets has not improved as much as expected. The initial gains in restructuring Prva Banka were partially reversed in 2014–2015. Although some improvements are seen in the Central Bank's supervision and risks management capacities, the 2016 FSAP highlighted gaps in crisis management and compliance with Basel Core Principles for Effective Banking Supervision. In addition,

7.2 Program's outcome rating was also affected by IEG's assessment of Bank's choice of PBG as an instrument for this intervention. The evaluation finds that macro and fiscal assumptions underpinning the use of the instrument were not in line with realistic projections available at program preparation. This shortcoming was augmented by the fact that the conversion of the planned FSDL operation into a PBG was done without mitigating macroeconomic risks. The program was a lost opportunity in terms of addressing important

<sup>15</sup> According to the Law on Budget and Fiscal Responsibility, if public debt exceeds 60 percent of GDP, the government should introduce a five-year plan to bring it below 60 percent.

macro and fiscal challenges that the country was facing to ensure fiscal sustainability and avoid large debt accumulation.

## **Risks to Development Outcomes**

7.3 The risks to development outcomes are rated significant.

7.4 In the years after the economic and banking sector crisis, Montenegro has strengthened its capacities to monitor financial sector risks and supervise the banks. The authorities learned a lesson from the recent boom and bust cycle and, on balance, are better prepared to withstand possible shocks through systemic risk monitoring. Possible build-up of excesses in the banking system is less likely than in the past. Prva Banka, the main source of concern in 2008–2011, was significantly downsized and poses no systemic risks.

7.5 Having said that, the risks to the banking system remain significant. This evaluation highlights that banking system transparency remains a concern. Gaps still exist in banking sector reporting, including lack of comprehensive reporting on loan provision and quarterly reporting. Valuation of collateral also requires more transparency. Asset quality assessment can be enhanced by external asset reviews— especially important given the relatively high ratio of nonperforming loans.

7.6 Risks remain from large nonperforming loans transferred to factoring companies that may still affect the functionality of the overall financial system. Currently there is no oversight over factoring companies that generates potentials risks. With respect to Prva Banka, in spite of substantial achievements, the Government continues to provide nonmarket financing to the bank through the deposits of public agencies.

7.7 Risks also remain to the development outcome because of macro and fiscal effects on the banking system as the result of possible economic volatility in the long term. The momentum from the fiscal consolidation of 2011 and 2012 was lost, creating slow expenditure reforms in critical areas such as pensions and public wages. Fiscal position was further weakened by large infrastructure projects. These factors contributed to a substantial increase in public debt to about 66 percent of GDP at the end of 2015 compared to about 50 percent as projected by the Bank and the government. Possible pro-cyclical fiscal stance may exacerbate the risks to the banking system through the potential of amplifying the business cycle.

## **World Bank's Performance**

### **QUALITY AT ENTRY—MODERATELY UNSATISFACTORY**

7.8 The operation was prepared against the background of a tense fiscal situation in 2012. Authorities were facing a large financing gap from the second wave of recession and expected debt repayments. To respond to Montenegro's large financing requirement, the second operation of FSDPL under preparation was converted into a PBG. Its indicative triggers that were mostly achieved by the time of the conversion were used as prior actions for the guarantee. By doing this, the Bank made a substantial amount of financing available

to Montenegro to help address its larger than expected external financing gap amid heightened macro risks. The Bank's financing was particularly important as the envisaged IMF program did not materialize because of diverging views on the scope of required fiscal consolidation. This evaluation finds that given the borrowing costs in the markets, providing additional financing to Montenegro was justified.

7.9 The main shortcoming in the Bank's performance was using macro and fiscal projections that were not credible and not in line with more realistic IMF projections to justify Montenegro's eligibility for the guarantee instrument. The Bank should have paid closer attention to macro and fiscal issues especially in light of the inability of authorities to negotiate a program with the IMF to address elevated fiscal sustainability risks.

#### **QUALITY OF SUPERVISION—SATISFACTORY**

7.10 Supervision was a proactive process that involved monitoring progress in banking sector reforms and overall economic development as well as technical support throughout program implementation in 2012 and 2013. This was mostly done through FINSAC by developing the Podgorica approach for resolving NPLs. The Bank worked closely with both the Ministry of Finance and the Central Bank. Program supervision coincided with the preparatory stage of the planned budget support operation on fiscal consolidation, which did not materialize. The Bank team provided input to that process based on knowledge generated through the guarantee's preparation and implementation.

7.11 Overall Bank performance is rated moderately unsatisfactory.

### **Borrower's Performance**

#### **GOVERNMENT PERFORMANCE—MODERATELY UNSATISFACTORY**

7.12 The government demonstrated overall strong ownership of the reforms to strengthen the banking system. With the support from international partners, including the World Bank, it developed a credible reform program for the financial sector to address many sources of vulnerabilities and improve crisis preparedness. Most critical actions were implemented with the support of the first operation of FSDPL. The actions planned by the government for the second operation and implemented under the guarantee further helped to strengthen the banking system, especially with respect to developing capacities for systemic risks management and banking supervision.

7.13 Despite these strengths, issues remained that authorities could have addressed more proactively to improve the reform's outcome. In particular, slow NPL resolution and re-accumulation of the government's deposits in Prva Banka ran against the spirit of the reforms. Transparency in the banking system remains an issue. Impediments to developing the mortgage market, such as the Consumer Bankruptcy Law complicating the use of collateral, have not been addressed. In addition, the government has recently initiated a lending rate cap aimed at reducing the spread through a draft law submitted to the Cabinet in late 2015, which may be counterproductive for financial system development. The FSAP

initially planned in 2013–2014 was conducted at the end of 2015 and finalized in 2016, which is a shortcoming because of the importance of independent diagnostics.

7.14 The borrower’s performance was also affected by the shortcomings in macro and fiscal management that created risks to fiscal sustainability with possible implications for overall economic performance and soundness of the banking system. Because of the lack of fiscal consolidation and introduction of large infrastructure projects with uncertain economic and financial implications, the debt to GDP ratio reached 66 percent in 2015 while public debt that includes loan guarantees reached 80 percent of GDP. It is expected to approach 80 percent over the next few years. Although Montenegro needs to upgrade its highway infrastructure to improve connectivity, the decisions have not been based on fiscal sustainability criteria. Political will to address key fiscal challenges and generate fiscal space for strategic projects through measures to reform entitlement programs and public employment, and to expand the tax base is weak. Fiscal challenges prevented authorities from developing a program with IMF in early 2012 and securing a DPO with the Bank in late 2012. An improved external environment since then has masked risks to market access, debt refinancing, and the cost of debt service, but they may materialize if the trends of 2013–2015 reverse.

7.15 Implementing agency performance is rated moderately unsatisfactory.

7.16 Overall Borrower’s Performance is rated moderately unsatisfactory.

## **Monitoring and Evaluation—Modest**

### **DESIGN**

7.17 The indicators selected for progress monitoring were linked to policy actions and were generally measurable and quantitative. Most results indicators were outcome oriented and were largely adequate for capturing the effects of policy actions. The target values established for the results indicators were adequate for the stated ambition of the program. The monitoring and evaluation framework drew on an update of the FSAP that was expected to occur in 2013–2014 but happened in 2016.

### **IMPLEMENTATION**

7.18 The Ministry of Finance coordinated data collection and reporting. The choice of indicators allowed most of them to be updated with more recent data at the time of the evaluation to assess the sustainability of achieved results. Non-implementation of FSAP in a timely manner affected the quality of the program’s monitoring and evaluation.

### **UTILIZATION**

7.19 No utilization was reported in the Implementation Completion and Results Report. The evaluation highlights that most indicators continued to be monitored as proxies of financial system stability after program completion.

## 8. Lessons

- PBGs can potentially be a useful instrument for supporting countries facing large external financing needs.
- PBGs implemented in a context of challenging macro-fiscal situation and large financing needs need to incorporate a consistent macro-economic framework with necessary macro and fiscal actions for risk mitigation.
- The choice of a PBG as an instrument should be based on robust macro and fiscal projections indicating that financing framework is sustainable and macro risks are mitigated. Montenegro's case indicates that eligibility for a PBG cannot be decided based on general announcements by the government that lack details. The case highlights once again the criticality of Bank-Fund cooperation.
- Comparing the aggregate interest rate of PBG-supported debt instruments with counterfactual market rates may not be enough for assessing the extent of reduction in the borrowing costs associated with the transaction. Estimating the change in sovereign risk perceptions, although a challenging task, may give more accurate assessment of the impact of the program.

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## Appendix A. Basic Data Sheet

### MONTENEGRO: FINANCIAL SECTOR POLICY BASED GUARANTEE (P130157, IBRD-G2130)

#### Key Project Data (US\$, millions)

|                     | Appraisal<br>Estimate | Actual or<br>Current<br>Estimate | Actual as % of<br>Appraisal<br>Estimate |
|---------------------|-----------------------|----------------------------------|---|
| Total project costs | 79.2                  | 79.2                             | 100                                     |
| Loan amount         | Not Applicable        | Not Applicable                   | Not Applicable                          |

#### Cumulative Estimated and Actual Disbursements

|                                     | FY12           | FY13           |
|-------------------------------------|----------------|----------------|
| Appraisal estimate (US\$, millions) | Not Applicable | Not Applicable |
| Actual (US\$, millions)             | Not Applicable | Not Applicable |
| Actual as % of appraisal            | Not Applicable | Not Applicable |

#### Project Dates

|                       | Original   | Actual     |
|-----------------------|------------|------------|
| Initiating memorandum | 01/05/2012 | 01/05/2012 |
| Negotiations          | 05/22/2012 | 05/22/2012 |
| Board approval        | 04/09/2012 | 05/18/2012 |
| Effectiveness         | 07/27/2012 | 07/27/2012 |
| Closing date          | 07/27/2013 | 07/27/2013 |

#### Staff Inputs (staff weeks)

| Stage of Project Cycle | Staff Time and Cost (Bank Budget Only) |   |
|------------------------|--|---|
|                        | No. of staff weeks                     | USD Thousands (including travel and consultant costs) |
| <b>Lending</b>         |  |   |
| FY12                   | 37.02                                  | 260.26  |
| <b>Total:</b>          | <b>37.02</b>                           | <b>260.26</b>   |
| <b>Supervision/ICR</b> |  |   |
| FY13                   | 2.59                                   | 8.89  |
| <b>Total:</b>          | <b>2.59</b>                            | <b>8.89</b>   |



**Task Team Members**

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| <b>Names</b>       | <b>Title</b>                     | <b>Unit</b> |
|--------------------|----------------------------------|-------------|
| <b>LENDING</b>     |                                  |             |
| Lalita Raina       | Sector Manager                   | ECSFE       |
| Martin Melecky     | Sr. Financial Sector Specialist  | DECWD       |
| Zeljko Bogetic     | Lead Economist                   | ECSP2       |
| Gianfranco Betozzi | Senior Financial Officer         | FABBK       |
| <b>SUPERVISION</b> |                                  |             |
| Michael Edwards    | Lead Financial sector Specialist | ECSPF3      |
| Lalit Raina        | Sector Manager                   | ECSF3       |

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## Appendix B. Prior Action

### Box 2: Prior Actions for PBG

The following constitute prior actions for presentation of the Loan to the Bank's Board of Directors:

FSC has:

- (i) carried out periodic systemic risk monitoring and taken appropriate macroprudential decisions as evidenced by written minutes of meetings and the assessment methodology used;
- (ii) adopted the national contingency plan including a draft *lex specialis* [the draft Financial Stability Law] granting extraordinary powers to CBCG and the Government to provide emergency liquidity and capital, if necessary, on declaration by the FSC of a financial crisis.

The CBCG has:

- (i) updated and approved supervisory action plans (SAPs) for 2012 for banks of special concern, based on completed on-site examinations, off-site monitoring and stress-test results as of December 2011, and made satisfactory progress in such SAPs implementation.

The Borrower and the CBCG have presented evidence showing that:

- (i) *Prva Banka* has made satisfactory progress in the implementation of all actions required by the 2012 SAP, maintains a CAR above 12 percent pursuant to the order issued by CBCG, and complies with all other regulatory requirements; and
- (ii) the Borrower has withdrawn central government deposits from *Prva Banka* in accordance with the agreed withdrawal schedule between the MoF and *Prva Banka* to ensure *Prva Banka*'s future financing on market terms.

The Borrower has enacted:

- (i) Regulation on Informing Depositors and Potential Depositors about Deposit Protection Scheme (Official Gazette 16/12, March 19<sup>th</sup> 2012), to bring public communication protocols vis-a-vis insured depositors in line with EU Directive on Deposit Guarantee Schemes 94/19/EC and 2009/19/EC.;
- (ii) Decision on Detailed Conditions, Manner and Procedure of the Guaranteed Deposit Payout (Official Gazette 16/12, March 19<sup>th</sup> 2012), to improve the efficiency and transparency of guaranteed deposit payouts.

The CBCG has, in order to implement the Standardized Basel II Approach, adopted the following regulations:

- (i) Capital Adequacy Decision, Official Gazette 38/11, July 1, 2011 on capital adequacy;
- (ii) Decision on the manner of calculating banks' exposures, Official Gazette 15/12, March 5, 2012 on large exposures; and,
- (iii) Decision on Public Disclosure of Information and Data by Banks, Official Gazette 2/12, December 29, 2011 on banks transparency and information disclosure under Pillar 3 of Basel II.

The CBCG has adopted the decision on Minimum Standards for Credit Risk Management in Banks, Official Gazette 22/12, April 12, 2012, implementing IFRS 39 for the banking system as of January 1, 2013.

The Government has, by its decision dated March 29, 2012, approved the Law on Financial Collateral, and thus improved the legislative framework for financial collateral and facilitated enhanced liquidity management at financial institutions.

## **Appendix C. List of Persons Met**

### **Government**

Mr. Igor Luksic, Former Prime Minister, Minister of Foreign Affairs and European Integration of Montenegro

Mr. Milorad Katnic, Former Minister of Finance

Mr. Nikola Vukicevic, Ministry of Finance

Mr. Dragan Darmanovich, Ministry of Finance

Ms. Bosiljka Vukovic-Simonovich, Ministry of Foreign Affairs and European Integration of Montenegro

### **National Bank**

Mr. Milojica Dakic, Governor

Mr. Darko Bulatovic, Director of Supervision

Ms. Zeljka Asanovic, Supervision Department

### **International Monetary Fund**

Mr. Alasdair Scott, Resident Representative, International Monetary Fund

### **World Bank Group**

Mr. Michael Edwards, Lead Financial Sector Specialist

Mr. Gianfranco Bertozzi, Lead Financial Specialist

### **Civil Society**

Mr. Mirko Radonjic, Association of Montenegrin Banks

Ms. Dragana Radevic, Institute for Entrepreneurship and Economic Development

Ms. Milika Mirkovic, Institute for Strategic Studies and Prognosis

## Appendix D. Borrower Comments



Podgorica, June 17, 2016

**Subject: Central Bank of Montenegro Comments on the Project Performance Assessment Report Montenegro Financial Sector Policy-Based Guarantee**

The Central Bank of Montenegro (CBCG) would like to thank the World Bank for financial and non-financial support granted to Montenegro. We also express our gratitude to the World Bank staff on professional and honest cooperation.

With regard to the mentioned document, we would like to present a number of our comments.

1. High level of NPL is mentioned in several places, i.e. in the summary (two places) and in paragraph 6.6. First, we would like to note that paragraph 6.6 contains incorrect information that NPLs totalled to some 15 percent at the end of 2015. The correct information is 12.57 percent. We would also like to note that the level of NPLs significantly dropped and amounted to 11.99 percent as at Q1 2016-end. This level is below the regional average. Therefore, we believe that the statement that the results are below expectations, given in several places in the study, is not justified.
2. Several places in the document pointed that the public debt reached the level of 70 percent at the end of 2015. According to our estimates, this level it is somewhat lower, i.e. about 65 percent. Moreover, the dominant reason for the public debt growth in 2015, and the expected growth in the coming years, resulted from the construction of the highway, being unknown in 2012 when the aforementioned project had been carried out.
3. Paragraph 6.4 should state that the crisis simulation exercise was conducted with the participation of representatives of the CBCG, the Ministry of Finance, and the simulated participation of the Deposit Protection Fund. We would also like to note that the Financial Stability Council (FSC) periodically discusses National Contingency Plan (NCP) at its meetings. Its discussion at each meeting is not necessary since this is a long-term nature document with circumstances not changing rapidly in the short run, and therefore there is no need to discuss it at every session, nor is has been the practice of other institutions.
4. The paragraph 6.10 contains incorrect data on the average interest rate of new loans in end-2015 (9.6 percent). The correct data is 8.12 percent. Consequently, the data on interest rate spread is also not correct.
5. Paragraph 6.17 has incorporated findings of the FSAP mission, which were not correctly interpreted, according to our opinion. We hereby repeat the comment submitted to the FSAP mission

"Paragraph 60 – This paragraph of the Report contains several statements that should be excluded from the report or modified. These are the following statements:



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"The aggregate limit for all related-party exposures is 200 percent of own funds, which is too high. There are also significant gaps in the definitions of "related party" and "related-party transactions." Although the law requires from Board of Directors to approve all transactions of related parties, some banks may assume exposures (up to 10 percent of bank's own funds) to related parties without prior approval of the Board of Director.

Limits for the exposures to bank related parties are defined in the Banking Law as follows:

- total exposure of a bank to all bank related parties may not exceed the amount of 200 percent of bank's own funds;
- total exposure to a party that is member of the board of directors, audit committee or executive director, including members of its immediate family may not exceed 2 percent of bank's own funds;
- total exposure to legal persons that are controlled by governing and management structure of a bank and/or members of their immediate families may not exceed 10 percent of bank's own funds;
- total exposure to an employee not referred to governing and management structure of a bank may not exceed 1 percent of bank's own funds;
- total exposure to a shareholder that does not have qualified participation in a bank, including exposure to legal persons that are controlled by such shareholder may not exceed 10 percent of bank's own funds;
- sum of the total exposure of a bank to the following parties may not exceed 20 percent of bank's own funds:
  - shareholders that have qualified participation in a bank, including exposure to legal persons that are controlled by such shareholders;
  - legal persons controlled by a party that controls the bank, and
  - legal persons controlled by the bank.

The aggregate limit of 200 percent of bank's own funds for all bank related parties may seem too high, at first glance. However, the analysis of the definition of related parties draws the conclusion that it is extremely conservative. This is due to the reason that, in addition to the entities who due to ownership and management status have the power to influence the conditions under which transactions with such parties are performed (shareholders with qualified participation, members of managers, and the bank's management), the definition of related parties includes persons not having power to ensure that a bank's transaction with those persons is performed under more favourable conditions.

In such situation, if we analyse the restrictions applying to persons who have actual or potential power to secure a certain privilege in transactions with the bank to themselves, these being significant shareholders and management and managerial structure of the bank, it will result as follows:

- Exposure to a person who is a member of the Board of Directors, the Audit Committee or the Executive Director, including members of his immediate family, may not exceed 2 percent of own funds. Banks usually have 5 members of the Board of Directors, three members of the Audit Committee and three executive directors, which means that for all these persons, including members of their families, the exposure may amount to a maximum 22 percent of bank's own funds. Bearing in mind that, in practice, one executive officer of bank is simultaneously a member of the Board of Directors, and that a being a member of the Board of Directors is a member of the Audit Committee, possible exposure to this group is even lower;



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- total exposure to all legal entities which are controlled by the management and managerial structure of the bank and/or members of their immediate families may not exceed 10 percent.
- strict limits have also been set for the category of persons who, under the ownership rights, may objectively affect the bank's transactions. Total exposure to all such persons (shareholders over 5 percent of capital, including the majority owners, as well as their subsidiaries, etc.) may exceed 20 percent.
- The sum of all these amounts equals to 52 percent representing the maximum potential total exposure of a bank to all categories that may be risky in terms of their impact that a transaction with them is executed under favourable conditions, provided that all these transactions are subject to specific procedures referring to transactions with related parties, additionally minimising risk. In addition, the majority owners of the bank have the obligation to cover the entire exposure with high-quality collateral.
- The remaining limit (148 percent of bank's own funds) is "reserved" for persons who do not have the power to, formally or informally, influence on decision makers. Although they do not have such power, limits are reserved for the categories that are more stringent than general rules (10 percent for shareholders with share of less than 5 percent in bank's capital, along with its subsidiaries and 1 percent for the employee together with his family members). We would like to note that comparative legal solutions of other countries usually do not treat this category of persons as bank related persons.

For these reasons, we believe that the aforementioned statement has to be excluded from the report, or adjusted to the factual state in the appropriate manner.

We also opine that the definition of bank related parties is comprehensive and more conservative than the good practice in this area because, in addition to persons who, due to the ownership or management positions may influence the decision-making formally or informally, it includes a large number of persons, who essentially have no or hardly may have the power.

The definition of bank related parties reads:

- members of bank's bodies, shareholders, bank employees, as well as members of their immediate family (marital partner and children);
- legal persons in which a party that has a qualified participation in the bank also has a qualified participation;
- legal persons in which one of the parties in bullets 1 and 2 of this point has significant participation, or a party referred to in bullet 1 above is a director or a member of the board of directors or other managing body of a such legal person;
- a party that has participation in capital or voting rights of at least 50 percent in a legal person that has qualified participation in a bank.

For these reasons, we opine that the statement "There are also significant gaps in the definition of related parties" has to be deleted from paragraph 60.

The same applies to the statement that there are gaps in the definition of the term "transactions with bank related parties".

To wit, Article 4 of the Decision on Minimum Standards for Operations with Bank Related Parties lists only some examples of transactions with related parties, but the term transaction with bank related parties is not limited only to those examples:

Paragraph 1 of this Article reads:



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Operations of the bank with the bank related parties under more favourable conditions shall be considered the following transactions in particular:....” The wording “in particular” in our legal system has the same meaning as the phrase “including, but not limited...” which is used in other jurisdictions, so the term “transactions” is comprehensively defined

When it comes to the approving of transactions with related party by bank’s Board of Directors, it should be noted that there is a significant number of transactions which character and values cannot aggravate bank’s operations even if granted under favourable conditions (loans of smaller amounts, deposits, opening current accounts and the like). The board of directors should not approve such transactions reasonably, as this would diminish the bank’s efficiency significantly, given that, as a rule, the Board of directors holds sessions on a monthly basis.

In their implementing legislation, banks determine the level of materiality requiring prior approval of the Board of Directors. Other persons make decision on these transactions, and the Board of Directors is regularly informed of these transactions. This is done in the manner providing full insight into the level of such transactions, their volume and the conditions under which these transactions are concluded, in order to assess these transactions contain elements pointing to operations under more favourable conditions, which is not allowed by law.

In cases where the bank determines inappropriate significance thresholds, as in the example given in this paragraph, the CBCG orders bank to correct these limits to the level providing the minimization of risks arising from operations with bank related parties.”

**THE END**