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Deloitte Touche
Tohmatsu

Slovenia Bank Rehabilitation Project

Final Report for Advisor to Nova Ljubljanska banka d.d.

Delivery Order No. 29
Contract No. EUR-0014-I-00-1056-00
Eastern Europe Enterprise Restructuring and Privatization Project

USAID

U.S. Agency for International Development
EUR/ENI

August 4, 1995

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August 4, 1995

Ms. Kim McKeon
AID/ENI/PER/ER
Room 3117, SA-15
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Re: Contract No. EUR-0014-I-00-1056-00, Deliverables for Delivery Order No. 29, Slovenia - Bank Rehabilitation Project -- Final Report for the Advisor to Nova Ljubljanska banka d.d. (NLB)

Dear Kim:

In accordance with Article IV of the above-referenced delivery order, enclosed please find the Final Report for the Advisor to NLB.

If I can provide you with further information, please do not hesitate to contact me at (202) 879-5386. Copies of these reports will be distributed as detailed in the delivery order.

Sincerely,

Lynne Damon
Senior Consultant

Enclosure

FINAL REPORT

CONTRACT:	**USAID Contract EUR-0014-I-00-1056-00, #29** **Slovenia Bank Rehabilitation Project**
DATE:	August 4, 1995
DATE OF WORK PLANS:	June 3, 1994 Work Plan for 6 month term; November 7, 1994 Work Plan for 2.5 month term; March 3, 1995 Work Plan for 3.5 month term;
CONSULTANT:	Mike Markels Deloitte Touche Thomatsu International
ASSIGNMENT:	Advisor Nova Ljubljanska banka d.d. (NLB) Ljubljana, Slovenia
LOCAL COUNTERPARTS:	Anton Macuh, Advisor to the Managing Board Urban Smerkolj, Advisor to the Managing Board

Summary:

It is gratifying that feedback from NLB management and staff and from USAID project officers has been very positive regarding the value added by this technical assistance. NLB team members deserve recognition for the accomplishments outlined below. Amidst rapid change, they invested the time and energy necessary to learn and implement new technology. This is hard, especially given that they all had other jobs to do.

At NLB's request, this technical assistance was extended twice from an initial term of six months to just over a year. As a result, there were three different Work Plans for this assistance, all of which were approved by NLB and by USAID. Detailed monthly reports presented progress against the goals established in the Work Plans. This document will not restate the material presented in the monthly reports; the reader can refer to Monthly Report #13 dated June 22, 1995, for a detailed analysis of each task.

This summary will present each task as follows:

- objectives
- distribution of time for this activity
- accomplishments
- problems and solutions
- lessons learned
- next steps

A. ACTIVITY (A): Design a securitization vehicle to allow the sale of loan assets into local capital markets.

I. Objective: To design a securitization vehicle that will work in this specific market context. Our second objective was to move the pilot transaction as far towards closing as was possible during my term.

II. Distribution of Time for this Activity: 35%.

III. Accomplishments:

1. **Pilot Transaction:** This design and preparation of the pilot transaction was conducted with a multi-disciplinary team of NLB staff, such that the technology passed to them. The transaction infrastructure is in place and the NLB team has been trained such that they can close the pilot transaction on September 1, 1995. To my knowledge, this will be the first securitization of bank loans in central/eastern Europe.

2. **Teamwork:** In addition to the transfer of securitization technology and its use as a tool to restructure the Bank's balance sheet, we accomplished a more fundamental goal. We fostered team work across divisions and departments. We formed two teams, a Core Team which did the work, and a Management Team which directed the Core Team. These teams consisted of staff from both business divisions. The investment bankers were packaging assets that were part of an important customer relationship, which is handled by the Corporate Division.

Team members included staff from several different departments as well: investment banking, corporate lending, treasury, accounting, internal audit, legal, loan servicing and project finance. Sub-teams completed specific tasks, and reported back to the Core Team. Perhaps the most gratifying and productive part of our work together has been its team aspect, led by local staff, advised by me. This is not typical in Slovenia; people tend to specialize and to guard their specialty. This teamwork is a significant accomplishment that will benefit NLB in areas such as cross selling, loan syndications, etc.

IV. Problems and Solutions:

1. **Grey Areas of Responsibility with the Bank:** This team work took significant effort to develop, particularly among the senior line personnel of the two business divisions. As far as I can tell, there was some sensitivity to turf (my deal vs. my client). This project spanned both divisions, which will be more typical in the future as new products and services are developed by the Bank (securitization, loans syndicated to foreign participants, investment banking advisory work for major borrowers, etc.). As the project gestated among senior line personnel, they worked

through these turf issues, which I hope **has** been a benefit to the Bank as a unified institution.

2. **Human Resource Constraints:** The second problem we encountered was the lack of human resources available within NLB to establish the legal, accounting and tax viability of this new technology. This difficulty is well documented in the monthly reports. The Bank's in-house legal staff has been downsized, and the lawyer selected for the team was very busy on other tasks. The accounting staff was in the throes of reacting to new Slovenian accounting standards. Because NLB has not had to pay taxes while in rehabilitation, there are no tax experts available in the Bank.

This project gained priority for our lawyer's time after we scheduled a three day work session away from the office. This time away was approved by the director of the Legal Department and senior management after we fell behind in drafting the legal documents. This productive work session gave critical mass to our legal effort; we wrote the drafts. After that, this project had a higher priority for NLB counsel.

Different accounting staff were selected for the Core Team during the crunch they were experiencing with other work, but they were not able to contribute. As a result, other Core Team members and myself, with the assistance of the Director of Internal Audit and our auditors, laid the financial accounting groundwork. In the last month we have again included the Financial Accounting Department in transaction design. They are better able to contribute now, and in August they will conduct a simulation of a payment cycle for both the loans and bonds.

We never were able to obtain tax expertise, so I did the tax analysis, with the assistance of the Core Team. USAID and Deloitte Touche had approved $5,000 for outside tax expertise, but the outside expert that we selected did not have the time for this project. As a result, the funds were never used. The Core Team and I did our own research, met with the regulators, drafted our understanding of the tax treatment of the pilot transaction, and delivered it to the regulators for written approval.

3. **Unresponsive regulators:** The third problem we encountered was unresponsive regulators. We submitted letters to three regulators: the Securities Market Agency, the Bank of Slovenia (central bank) and the Ministry of Finance (MOF), with a copy to the Department of Legislative Interpretation.

From the Securities Market Agency, we requested an interpretation of the law which would allow us to issue bonds in a private placement to a syndicate. The syndicate would then be able to sell the bonds publicly, through a listing on the exchange. The Agency's formal response was to restate the current law, in effect denying our request.

From the Bank of Slovenia, we requested their ruling on the capital adequacy treatment of the transaction on the Seller's books, and on the books of banks which purchase bonds as investors. We answered their initial questions. However, the central bank never addressed our request for a ruling, even after repeated requests through the Banker's Association,

From the Ministry of Finance, we requested formal confirmation of the tax treatment of the transaction. In the fall of 1994, we had two productive meetings with the Advisor to the Ministry for tax issues. In the summer of 1995, he indicated that the Ministry would not provide any confirmation of tax treatment. We sent a formal request, and are waiting for a response.

4. No local experience or legal basis to establish special purpose vehicle to act as Issuer: The capitalization and court registration of the Issuer is a critical path task, without which the pilot transaction cannot go forward. We have yet to accomplish this task. NLB and I have invested significant time to educate one physical person and one legal person (outside of NLB) in the technology such that one of them would establish the Issuer. The physical person backed out, and we are still negotiating with the legal person.

Slovenian law does not recognize the trust as a legal form of organization. As a result, the Issuer will be a limited liability company, which issues bonds to finance the purchase of the loans from the Seller. The company has the single purpose of one transaction, owns only the securitized assets, and will be dissolved once the bonds and loan assets have been fully amortized. Importantly, the company cannot be owned by NLB (the seller), because it would be consolidated with NLB's balance sheet. This would defeat the purpose of securitization: to move the assets off of the seller's balance sheet. So we must look outside of the Bank for the owner and director of the Issuer.

My counterpart first referred me to an entrepreneur who was previously employed by the Bank, but who now has her own consulting business. In the end, she felt like a mouse in an elephant cage, and decided not to establish the Issuer on her own account. We then turned to another bank in Ljubljana, Bank Noricum, in which NLB has a minority stake. Noricum brought institutional power in the form of legal expertise and human resources. They failed to bring senior management commitment, however, even with encouragement from NLB senior management.

Noricum management, as parent of the Issuer, has two basic concerns. First, they want to make money for little or no risk. Their upside comes from fees paid by the Issuer to Noricum. Instead, they want the Issuer to make a profit. This does not work because for every unit of profit, a portion is given to the government in taxes, which saps yield and reduces the sales price on the loans to NLB.

Second, Noricum management feels a moral commitment to stand behind the obligations of the Issuer, because it will be one of their subsidiaries. An key element of securitization is that the bond holders bear the credit risk beyond any credit enhancement from the Seller. We were able to educate Noricum's staff, but failed to educate Noricum senior management and Board of Directors about the limitation of their risk and the source of their revenues with this technology. We are still pushing for an August resolution of this problem in time for a September 1 issue date.

V. Lessons Learned:

1. **Product Innovation:** The primary lesson is that product innovation is possible in small, emerging capital markets, but that it takes more up-front work than you ever expect. The reason is that you are changing more than technology; you must also change basic practice and habit. For example, we decided early on that we would minimize the risks of the transaction to the Seller and bond holders by doing our homework first. But regulators are not willing or able to provide advance rulings. So you have to use personal connections and lobbying to obtain whatever assurances you can. This is part of the learning process for the regulators, because once outside investors and advisors are allowed to participate (not yet in Slovenia), regulatory uncertainty will have to be reduced.

2. **Required Resources:** The second lesson is that only the most powerful institutions (like NLB) which have committed to devote significant human resources can attempt such an ambitious project.

3. **Donor Assistance:** The third lesson is that the introduction of new technology and products like securitization (which is relatively high tech compared to other activities in the Bank), would never happen in the near term without technical assistance from a donor organization.

4. **Allow Refinement of Assistance Plan:** The fourth lesson is that the tasks in a technical assistance program should be allowed to evolve. The work must stay focused according to specific work plans, but different technologies can be used to accomplish the same objectives. The impetus for this assistance came from the need to restructure the Bank's balance sheet and to broaden opportunities for cheaper funding. In addition, it was hoped that the assistance would reduce the segmentation of Slovenia's banking system by allowing the banks to trade assets and funding based upon comparative advantage. We accomplished these objectives with securitization, but also with loan syndications and the other projects in the updated work plans.

VI. Next Steps:

1. Make final changes to transaction documents
   a. Prepare repurchase agreement (commercial basis) for NLB market making
2. Receive approvals from regulators
   a. Central Bank re: our proposals for capital adequacy treatment of transaction
   b. Ministry of Finance re: confirmation of tax treatment
3. Establish Issuer organization via Bank Noricum
   a. Capitalize and register Issuer in court
4. Conduct simulations of closing and of money transfer during one payment cycle
5. Monitor competing investments; adjust structure of bonds as necessary
6. Complete second round of test market; finalize pricing
7. Receive final go/no go decision from NLB management
8. Distribute offer and Private Placement Memorandum to target investors
9. Price and Issue securities (September 1, 1995 target date)

B. ACTIVITY (B): Design the refinancing of NLB's exposure to large real estate assets through placement with domestic and foreign sources.

I. Objective: To design a financial vehicle to liquify NLB's exposure to a major office property that is owned by a subsidiary of NLB. Refinance NLB's loan to the owner. The focus of this activity changed from securitization to refinancing due to a strategic decision by NLB and the Bank Rehabilitation Agency (BRA).

II. Distribution of Time for this Activity: 20%.

III. Accomplishments: NLB's owner, the BRA, required that NLB reduce its lending and/or ownership exposure to this large asset in order to boost the Bank's capital and to improve its balance sheet. Refinancing the existing NLB loan with outside sources has a dramatic effect on capital because NLB is forced to reserve against capital 100% of a loan to a subsidiary. From scratch, we formed a multi-disciplinary team which has accomplished the following:

1. Recommended disposition strategy to management and to the BRA based on evaluation of alternatives.
2. Completed thorough due diligence of the asset.
3. I wrote a rigorous cash flow model of the asset, including valuation and underwriting analysis. The analysis was used to structure the mortgage loan and to make marketing presentations to underwriters. The team was trained on the theory and actual use of the model for future transactions. In addition, the model and its

results were used to train LB HIPO management and staff in property management methods (i.e. expense reduction analysis using financial ratios; setting aside reserves for future replacements, etc.).

4. Structured the new loan to refinance NLB's loan to its subsidiary (DEM 20 million).
5. Offered the loan via NLB's representative office network.
6. Made marketing presentations to underwriters.
7. Received and negotiated an offer from an underwriter that represents a syndicate of foreign banks.
8. The transaction is projected to close in September 1995.

The project team was composed of staff from both business divisions and from NLB's asset management subsidiary (LB HIPO), which is also the owner of the property. Departments involved included International Correspondent Banking, Legal Department, the newly formed loan syndication group within the Corporate Division, the Project Finance Department and early on, accounting. As with the securitization project, a significant accomplishment was to foster teamwork and synergy among staff throughout NLB whose skills were necessary for success.

This project was relatively straight forward. During the design phase, the multi-disciplinary team worked well. Once we went into the marketing phase, the initial leader (Anton Macuh) left Ljubljana to take on other duties, and a professional from International Correspondent Banking became the coordinator. My role was to transfer major market technology to NLB by example and by training the staff involved in this important transaction. I transferred the following technology: property management (expense analysis, ratio analysis, planning for investment and replacements, etc.), valuation, commercial mortgage loan underwriting, structuring and documentation, and cash flow modelling.

Our work on this project identified the need for importing other major market technology to NLB, which we accomplished by setting up new projects with clear objectives and teams. They include loan syndications to foreign and domestic participants, real estate appraisal and underwriting standards, and mortgage loan documentation that protects the lender in a default situation. These projects are outlined below under Activity D.

IV. Problems and Solutions:

1. **Keeping the Team Together and Motivated:** It was difficult to keep the design team together during the marketing phase, which was conducted by the Correspondent Banking Department. Staff became dispirited as different lenders declined and options seemed scarce. My role was a sort of cheerleader at this time, and I tried to encourage continued meetings and problem solving among the team members from different departments. This lack of communication was a problem when the amortization method presented

by a representative office was not modelled beforehand, with the danger that the offer could not be supported by the property. It turned out that we were able to justify the offer with the addition of a reserve fund, so there was no damage done. The communication problem was solved when the Executive Director called the team together in preparation for a marketing presentation to some outside underwriters.

V. Lessons Learned:

1. Per problem #1 above, keep the team together through all phases of a transaction so that all of the skills available in the Bank are utilized through closing. Communication across departments and divisions is a key success factor.

VI. Next Steps:

1. Executive Director to negotiate final pricing with underwriter.
2. Assist team with review and comments of underwriter's draft loan agreement.
3. Work with lender's appraiser to receive favorable valuation.
4. Assist with closing as requested.

C. ACTIVITY (C): Review existing financial instruments sold by NLB and design new instruments suited to the local market.

I. Objective: First, to structure the securities in support of activity (A). Second, to provide Management with a recommendation which corrects the currency and tenor imbalance on NLB's balance sheet. This includes structuring replacement bonds for the existing rehabilitation bonds owned by the Bank.

II. Distribution of Time Required for this Activity: 10%.

III. Accomplishments:

1. **Structured Bonds for Securitization Project:** The Securitization Core Team structured the bonds to closely match the loan collateral, thereby minimizing any mismatch on the Issuer's balance sheet. Staff from the Investment Banking Department visited over twenty prospective investors in two rounds of market testing to confirm that this structure, while new for Slovenia, is acceptable to the current market situation. In addition, we conducted monthly surveys of competing investments such that we understood the pulse of supply and demand.

2. **Recommended how to Restructure of the Rehabilitation Bonds:** I collaborated with an Advisor from Allied Irish Bank to produce analyses and recommendations to NLB management and to the

Republic of Slovenia for the restructuring of the rehabilitation bonds on NLB's balance sheet. Early in the rehabilitation process, non-performing loans were swapped by NLB to the government in exchange for long term rehabilitation bonds (DEM 8% fixed interest rate). NLB is funded by short term Tolar deposits, causing an open interest rate and currency exposure for a significant portion of NLB's balance sheet.

We were responding to a proposal from the MOF, which was drafted with the assistance of U.S. Treasury Advisors. Our recommendation was based on the need for the Republic of Slovenia to complete the rehabilitation of the Bank by eliminating or fixing the open currency and interest rate exposure described above. The MOF proposal simply changed the exposure, but failed to fix it. If our recommendation is followed, NLB will be able to fix (quantify) and write off this exposure, paving the way for future profits. The write-off will be significant, and will require recapitalization of the Bank.

IV. Problems and Solutions:

1. **The Risks of Innovation:** Local investors in emerging capital markets have relatively little experience with basic products, such as variable interest rate bonds, or market standard interest rate indexes. In structuring a new product, incremental innovation is the rule. However, asset finance requires that the bond be structured to approximately match the cash flows produced by the underlying collateral. In this case, the underlying loans are floating at NLB's prime lending rate, at rate which is perceived to be set by a political decision, motivated by NLB's needs, not calibrated to competing investments in the capital market. Given no experience with variable rate bonds or market standard indexes, we were concerned that variable rate bonds at NLB prime minus one percent would be difficult to sell. Initially we structured the bonds with a fixed interest rate, which resulted in interest rate risk for the Issuer and a larger reserve fund. We became more aggressive as we educated target investors, however. Our test market indicated that we could successfully market a variable rate bond.

2. **The Effects of a Restrictive Monetary Policy:** Slovenia, like other emerging markets, suffers from high inflation. It is also a net exporter, which provides its banking system with an excess of foreign currency. These factors cause two problems for the team that is structuring marketable securities.

First, the Bank of Slovenia (BOS) has been issuing bonds at very high yields to draw hot money out of the economy and to reduce inflation. These bonds crowded out investment in production and financial assets, and are unbeatable competition for asset backed bonds. To issue asset backed securities against above market competition causes an unacceptably heavy discount on the sale of the loans by NLB. With each new tranche, the BOS reduced the yield, such that the most recent tranche does not crowd our proposed bonds out of the market.

Second, the relationship between the inflation of the Tolar on the one hand, and the exchange rate between the Tolar and the DEM on the other hand, determines the investment patterns for the majority of Slovenian investors. In order to partially redress the imbalance on NLB's balance sheet, we are securitizing DEM denominated assets which are paid in SIT. Early in the project, DEM denominated assets were in vogue; now SIT denominated assets are hot, all because of a shift in the inflation/exchange rate relationship shown above. This makes our bonds more difficult to market. The only solution to this problem is the proper timing of the bond issue, and selectively targeting investors that have particular balance sheet management needs that can be filled by our product.

3. **Restructuring the Rehabilitation Bonds**: Our technical assistance laid out the trade-offs among various options in a formal and thorough manner, but it will take political will to implement a solution that makes privatization of NLB possible. The problem is the competing interests between the Republic of Slovenia budget, as represented by the MOF, and the cost to truly rehabilitate NLB. As proposed, the MOF wants lower cash outlays than the current yield on the rehabilitation bonds. This would require a write-off of essentially all of NLB's capital. Prior to, or concurrent with privatization, NLB's open currency and interest rate exposure must be quantified and written off, and the Bank must be recapitalized. The timing and method of these actions will be a product of the political arena. I am told that it is unlikely that the administration will go back to Parliament for a recapitalization, given that the MOF has declared NLB rehabilitated. Because elections are in 1996, some sort of muddling through will probably continue into 1997.

V. <u>Lessons Learned</u>:

1. **Tradeoff between Product Innovation and Marketability:** The structuring team must balance the degree of product innovation with the willingness of prospective investors to buy (or prospective seller to sell) something that is new to an emerging market. Only through education, personal selling and demonstration of direct benefit can perceived innovation risk be overcome. This project demonstrated that direct selling is best accomplished by local bankers who have been thoroughly trained with a hands on transaction by the Advisor.

2. **Technical Assistance and the Political Process:** Technical assistance can influence high level political decisions by clearly showing the trade-offs among the options for the various institutions involved. The struggle among those competing

interests has to be hashed out by Slovenes in the political process, however. Regarding the privatization of the Bank, perhaps the muddling through is a sign that a real democracy is emerging. The alternative might be a clear mandate from a more authoritarian regime, but this approach runs the risk of too rapid change and displacement of existing power centers. The Slovenes have obviously chosen an incremental, not shock, approach.

The problem with this incremental approach is that the real restructuring of companies and the Bank will not occur until it is forced by recession. Slovenian exporters, which provide relatively high quality product and service for a high price and with a high cost base (relative to Visegrad competitors), are now tied to Western European markets. The coming recession and flight to low cost producers will be challenging for Slovenia, its companies and the Bank. Some of the Visegrad competition has restructured, has invited foreign technology, management and capital, and retains a low cost base. They will be tough competition in the coming European downturn.

VI. Next Steps:

1. Receive and respond to the MOF's new proposal to restructure the rehabilitation bonds.

D. ACTIVITY (D): Provide training in the design and use of financial instruments, and in project finance, loan syndication and loan participation techniques on an individual transaction basis. Projected date complete: June 30, 1995.

I. Objectives: To train NLB transaction teams and outside actors such that:

1. project finance techniques are transferred to transaction teams;
2. loan syndication technology is adapted to the Slovenian legal and market context for use by NLB transaction teams;
3. securitization technology is transferred and the pilot transaction is closed.

II. Distribution of Time for this Activity: 30%

III. Accomplishments:

1. Wrote rigorous cash flow model of major office property, owned by a subsidiary of the Bank, which includes valuation (discounted cash flow and capitalization of net operating income) and underwriting of a market rate loan (debt service coverage and loan to value ratios). Trained LB HIPO and NLB staff on the theory and use of this model for use in Activity B and for future transactions. Trained staff in expense reduction analysis.

2. Trained NLB staff in Ljubljana and New York on the Bank's underwriting of its participation in a syndicate to finance new office construction in Warsaw. This team assessment of commercial risk was undertaken at the request of the Executive Director, International. This hands-on training resulted in:

- a favorable transaction; NLB's risk was minimized in a risky transaction with the addition of cash collateral;
- NLB staff is trained to properly assess the risks and to negotiate appropriate structure and fees for participation in future syndicates.

3. Trained valuation staff in the Project Finance Department on appraisal theory and methods for commercial and residential real estate. Imported instruction and source materials and initiated contact with the Appraisal Institute and the Eastern European Real Property Foundation (EERP).

4. At the request of the Executive Director, Corporate Division, I conducted an analysis of NLB's loss on a loan to Pionir, a construction and engineering firm. NLB's loans to the firm were collateralized by production facilities, which were re-valued at a fraction of their recent appraisal. The key was that the original appraisal used only a modified cost approach, which does not take market realities into account, and has little to do with market value. This analysis confirmed the need for the Bank to require the income and sales comparison approaches to valuation in its appraisals.

5. Initiated and pursued cooperation among the institutions in Slovenia which have different interests in the creation of new, major market appraisal standards in Slovenia. These key institutions are the EERP, NLB appraisal staff, the Banker's Association, the Bank of Slovenia, the Ministry for Building and Environment, the Ministry of Justice, FIABCI Slovenia (association of real estate professionals), and the Privatization Agency.

Currently there are different standards recognized by the courts, the banks and the privatization agency. Our goal is to bring a rigorous standard to the banks for underwriting, monitoring and foreclosure proceedings. The challenge is to have the same new standard recognized by the courts, which control the foreclosure process and which recognize only an outdated cost approach.

6. Trained a new, multi-disciplinary team of NLB staff in the syndication of three separate loans to foreign and domestic participants: Intercontinental Hotel (DEM 9 million), contractors to DARS (Republic of Slovenia road building agency) and TR3 the office property (refinancing described in Activity B above; DEM 20 million). The team of six staff was drawn from both business divisions, and included two attorneys. Regarding the DARS syndication, I directly advised the senior manager. My advice

focused on NLB participating only on a commercial basis, including underwriting techniques and the relationship among the domestic participants.

7. Imported commercial mortgage loan documents from US counsel. Trained NLB staff (the syndication team) on key concepts and language that protect the lender in the case of borrower default. Lender protection via the foreclosure process is very poor in Slovenia, and there is no non-judicial enforcement mechanism in Slovenian law (deed of trust). The assignment of leases, rents and management contract, coupled with a form of lock-box procedure, is the best technology that we could transfer for the Intercontinental transaction. This technology, newly enshrined in NLB's standard documentation, will protect the Bank on future deals as well.

8. Trained NLB staff, regulators and prospective investors on the fundamentals of securitization, and on the specifics of transactions collateralized by bank loans and by real estate. Trained NLB management and staff on the transaction alternatives that would best restructure the Bank's balance sheet in preparation for privatization. This led to the selection of the bank loans that will be securitized in September 1995.

IV. Problems and Solutions:

1. **Passing the Baton:** After I wrote the cash flow model and trained NLB staff on theory and practice, I continued to be the one to run the numbers as the sale transaction in Activity B progressed. My role is to transfer the technology, not to repeatedly run the numbers. Only after months of prodding was I able to schedule a hands-on training session in which eight NLB and LB HIPO staff learned to use the model, each with their own PC, doing exercises. I am still trying to wean them off of my skills, such that they use their new training for the transactions at hand. In part, the staff's resistance comes from it not being clear to them that these analyses will be a part of their future responsibilities.

2. **Wait for the Crowd, or Go It Alone:** Competing interests among the institutions that require appraisals and among various groups of appraisers will make it very difficult to establish one standard in Slovenia. The EERP has been successful in facilitating the creation of one standard in Poland and elsewhere, but before we bring them here, the Slovenes have to decide that they want to create one superior standard.

The Ministry of Justice is the furthest behind the times. They have a certification process and an appraisal standard (outdated cost approach, which has nothing to do with market value) set by an old Yugoslav law (1988), which is mandated for all foreclosure sales. The appraisers with that certification are relatively old, and have little interest in innovation or recertification.

The Privatization Agency is furthest ahead. They have implemented ASA ethical standards and a certification process, but have no published appraisal methods, formats or requirements. The banks desperately need to use all three approaches to valuation (income, sales comparison and cost) to improve loan underwriting. Major losses on loans collateralized by real estate are appearing, much to the surprise of management. Finally, the Bank must have these new standards incorporated into its credit manual and procedures.

The solution will probably be that the banks, through the Banker's Association and with the concurrence of the Bank of Slovenia, will establish their own appraisal standards, perhaps with the assistance of EERP. The Ministry of Justice may or may not change with the times.

3. Resistance: There is a general resistance to implement new technology on current transactions, even within the Bank. For example, on the Intercontinental commercial mortgage loan transaction, I met with resistance at several levels in my effort to require additional collateral to protect NLB in case of borrower default: the assignment of leases, rents and management contract. Rationale went from "credit committee did not require it", to "we don't have time" to "our payment system doesn't allow it". Through careful drafting of the loan documents, NLB did gain both the legal right to this additional collateral, and the mechanism to enforce this right,

V. <u>Lessons Learned</u>:

1. **Persistence:** To see new technology implemented, the Advisor must act like water on a rock; never give up. At each level of the organization, new technology initially creates more work and headaches than doing it the old way. As implementation is resisted, the Advisor must demonstrate the benefits and push the issue up to the management level where the decision to implement will be made.

VI. <u>Next Steps</u>:

1. We are now in the process of bringing the various institutions which commission or regulate real estate appraisals together to create one standard for both residential and commercial properties. We hope to import a training package from EERP (already designed), funded by USAID, to facilitate the drafting and approval of major market standards by Slovenes, customized to the Slovene market. If this is not feasible in the near term, then NLB will develop new standards, perhaps under the auspices of the Bankers Association, produce training materials and seminars, and approve a short list of qualified appraisers.

2. Given the success of our loan syndication project, the next step is to draft standard documentation and procedures for the sale of participations in existing loans.

E. **Activity E:** Develop mortgage based financing which will increase the availability and affordability of mortgages in Slovenia.

I. Objective: As part of a multi-disciplinary project team, design a primary mortgage instrument and a secondary market funding mechanism for approval and implementation by NLB and other key actors. NLB's goal is to provide better products for its depositors in order to stabilize those deposits.

II. Distribution of Time for this Activity: 5%.

III. Accomplishments: The Mortgage Team was formed within the Corporate Division, led by the Deputy Director. Sub-teams performed assigned tasks and reported to Project Team. This project is 50% complete. Accomplishments include:

1. Trained the Project Team on the basics of US and German mortgage finance, including underwriting, mortgage insurance and other mortgage market infrastructure useful for Slovenia. Used source materials imported from the US, the Urban Institute in Budapest (USAID Contractor) and from the Association of German Mortgage Banks.

2. Imported residential mortgage loan application form and documents from the US, which are being used as the basis for new NLB documents. Assisted team with new standards for lending to physical persons, including credit underwriting.

3. Drafted and sent proposal to the largest Slovenian insurance company to encourage their development of a mortgage insurance product which would complement NLB's new mortgage product. Met with officials of the insurance company, and analyzed the prospects for mortgage insurance in Slovenia. The concept is to create a risk sharing arrangement among the borrower, the lender and the mortgage insurer.

4. Conducted the analysis and drafted the formal recommendation, made to the major of Ljubljana, for a cash flow subsidy program that would bridge the gap between market rate mortgages originated by NLB and affordable interest rates.

5. Submitted basic mortgage design proposals to NLB management for refinement and approval.

6. Produced cash flow analysis of a new mortgage design suggested by a team member.

IV. Problems and Solutions:

1. **Legal Heritage:** Slovenian law is debtor friendly to the point that lenders and insurers have little or no recourse to an occupied property if the borrower defaults. The result is low loan to value ratios (40%), the requirement of additional collateral and co-signers, and recently, a Central Bank decree that an owner-occupied residence cannot be used as collateral for a mortgage!

This constrains NLB in its mortgage design and target customers. As a result, we are pursuing complementary subsidy arrangements with the government and risk sharing arrangements with an insurance company.

2. **Interest Rate Environment:** Another key problem with affordability in Slovenia is the cost of funding. With high funding costs for Tolars, mortgages are expensive.

3. **No credit checks:** NLB has relatively little experience with the assessment of the credit worthiness of physical persons. There are no credit services in the country, and NLB has payment history information only for its own depositors. Information on past bankruptcies is also not available. Loan applications which ask for borrower financial data are a new idea in Slovenia, and will provide the first line of information for applicants who have not been past depositors at the Bank.

V. Lessons Learned:

1. **Regulatory Interference:** Our best laid plans have been set back by the above-mentioned decree from the Bank of Slovenia which strikes down the use of owner-occupied housing as collateral for mortgage loans. We will work with the central bank and try to reverse this decree. The lesson is that the product development process must also include the regulators.

2. **Special Situation:** Mortgage innovation will have the effect of releasing home equity into the savings and capital markets, much to the benefit of the economy. But this will take time. An efficient mortgage market requires infrastructure not yet available in Slovenia, from credit assessment to legal remedies for the lender in case of borrower default.

With all of the problems outlined above, Slovenes are remarkably well housed. There is a decreasing and immobile population, which means that new housing stock is not needed (except for those trading up). Renovation of existing stock is needed, but Slovenes will do it themselves after regular work hours and without mortgages.

The squeeze is affordability, which falls on new entrants into the market who have no equity. This is the same problem as in the US, but here the equity requirements are twice as high relative to the price of the dwelling.

VI. Next Steps:

1. Complete mortgage design and submit to management.

2. Draft mortgage loan application and transaction documents.

3. Incorporate features that will enhance sale in the domestic secondary market.

4. Continue negotiations with the government to create targeted subsidies, and with the major insurance company to create a complementary mortgage insurance product.

5. Test market the mortgage. Institutionalize the product with policies, procedures and training.