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Barents Group LLC

Bank Rehabilitation Assistance

Macedonia Financial Sector Assistance Program Quarterly Report for the Quarter Ending June 30, 1997 and Final Report dated August 1,1997

Project # 1100-001
Contract # EPE-I-01-95-00048-00
Task Order # 001
Name of Project Office: Mr. John Glover
Name of Contracting Officer's Technical Representative (COTR): Mr. J. Grossman

Prepared by Lori B. Yerzyk, Project Coordinator
with information from Resident Advisor Taber

August 1997

Background

This technical assistance program, which commenced February 1, 1996 under the Omnibus B contract, is being carried out in accordance with the task order referenced on the cover page. The team structure consists of :

Washington, DC
James E. Horner, Project Manager
Lori Bittner Yerzyk, Project Coordinator

Macedonia
Larry Boren, Onsite Inspections Resident Advisor
Alan Hawkins, Bank Rehabilitation Resident Advisor
Greg Taber, Bank Rehabilitation Resident Advisor

For purposes of reporting, the program has been divided into two parts: Onsite Inspections and Bank Rehabilitation.

The task objectives are:

- Support the development of a professional bank supervision department at the National Bank of Macedonia

- Support the development of the government's capacity for resolving the problem of impaired loan portfolios at state banks.

This Report is only intended to discuss activities for the Bank Rehabilitation technical assistance program. The Onsite Supervision program will be addressed separately.

Bank Rehabilitation

The technical assistance program was originally scheduled to end December 31, 1996. However, the Bank Rehabilitation Agency (BRA) requested that our two advisors be extended. The BRA requested up to an additional eight months of assistance. The contract extension was received April 30, 1997. The focus of the extension was to enable the advisors to continue their efforts and to further enhance and implement processes, policies and procedures. Additionally, the extension allowed for continued training of the Project Directors.

The modified contract Objectives and Scope of Work remain the same, however, the Tasks and Benchmarks were revised to reflect the additional duties and extended contract term.

Tangible Results

The Tangible Results to be achieved as a result of the technical assistance as reflected in the Task Order are as follows:

- The bank rehabilitation authority will have developed operating procedures and guidelines for disposition of assets under its mandate.

- The bank rehabilitation authority will have developed a training program in asset disposition.

These Tangible Results for the most part have been achieved. As this report will detail, substantial technical assistance to achieve these objectives was provided. The BRA was able to adopt and institutionalize many of our advisors' recommendations. However, due to staff constraints, many of the recommendations and training provided to the BRA was not utilized as fully as we had anticipated. Even though there were limitations, we believe that a base of information/knowledge has been provided in which the BRA staff may refer to in the future as additional experience is gained and staffing/resource limitations are resolved.

Technical Assistance Activities

The Workplan is divided into four categories -Policies, Procedures, Systems & Controls; Documentation & Reports; Training; and Oversight, Asset Management & Disposition Issues. Activities accomplished in each of these areas are described below.

INTRODUCTION:

This is the Final Report for the Bank Rehabilitation Agency ("Agency" or "BRA") project and covers the period from February 1996 to August 1, 1997. This report also replaces the Quarterly Report for the period ending July 31, 1997. Although the original contract and Workplan for this project expired on December 31, 1996, it was extended by USAID to August 31, 1997, according to the Agency's written request, dated November 8, 1996 to extend the project for an additional six to eight months, or longer. At the request of the Contractor (Barents Group, LLC), and with the approval of USAID and the Agency, the project terminated on or about August 1, 1997.

This report attempts to summarize all significant items, but cannot include all work performed. Please refer to monthly and quarterly reports for greater detail on tasks performed and on progress over time.

There were no changes in the BRA's activities and/or responsibilities that significantly altered the facts presented in the previous Monthly or Quarterly Reports.

SCOPE OF WORK:

During the project term, Resident Advisors submitted monthly reports as well as five quarterly reports, which addressed specific work performed and summarized the major findings of the Resident Advisors. All previous reports have been reviewed and found generally acceptable by Ms. Linda Gregory, OAR - Skopje. Most recent reports have also been reviewed by Mr. Steve Gonyea, Private Sector Specialist.

Work was performed according to a Work Plan submitted March 1996, for the initial project period ending December 31, 1996. Upon approval of the project extension, Advisors submitted a supplemental Work Plan for the period from January 1 through August 31, 1997. The plan was accepted and reviewed by USAID without formal comment; nevertheless, Advisors used it as their guide for work performed during the extension period. Many of the more important items addressed were continuations of benchmarks set in the previous Work Plan. Several of the proposed items were tentative, and whether they would be performed was to be based on an initial review of each applicable situation. In addition, accomplishment of several of the Benchmarks was contingent on the occurrence of particular events or conditions. Generally, all major Benchmarks were met or exceeded. Some less critical Benchmarks on the Supplementary Work Plan were not completed due to lack of need, as determined by initial assessment, or due to the contingency not taking place.

An important contingency that has adversely affected most areas in which the Advisors worked is the addition of adequate personnel to handle Advisors' recommendations on analysis and documentation. As a result, late in the project, significant shifts in the orientation of the Agency have been recommended, to greater emphasis on loan and equity sales.

Following is a summary of the work performed and issues related to each of the Tasks/Statement of Work as outlined in the Task Order:

Policies, Procedures, Systems & Controls

Substantially all of the advisors' activities in the establishment of basic policies and procedures were completed by the end of the third quarter 1996. The Advisors had presented the Agency with revised and/or suggested amendments to policies and procedures related to its asset management and disposition responsibilities. Except for our suggested amendment to policy for interest rates on BRA restructured debt, all of the recommendations have now been adopted by the BRA Board of Directors in substantially the form suggested. Thus, this Task, as it relates to the Agency's primary responsibility of managing and selling debt and equity, has been completed.

As discussed in previous reports, the advisors limited the scope of this effort to conform to the human resources currently available to the Agency. Although we would not consider the current level of policies and procedures adequate in a fully staffed environment, they should be viewed as acceptable given the Agency's small number of staff in relation to the number and complexity of loan and equity assets. Some additional Advisor efforts were expended in this area during the most recent quarter. Continual refinement of existing policies and procedures was made on an "as needed" basis as requested by the Agency's Director, Mr. Jevdet Hairedini.

Based on the Director's input, the Advisors did not pursue the development of policies and procedures for the Agency's accounting and payment processing functions. Although we believe there is a need in this area, the Director indicated he preferred that we concentrate our efforts in other areas.

<u>Organization Chart & Position Descriptions</u> - This task was completed in May 1996. Although the Director verbally indicated on several occasions that he substantially agreed with the proposed organization chart and was pleased with the various position descriptions developed, the adoption of our recommendations has been limited. In the most recent quarter, the Senior Project Director was promoted to the newly created position of Assistant Director. This position, which involves different duties than the person had fulfilled before, was essentially that recommended by Advisors in our reorganization plan. Though this was an important step, some other actions remain to be taken, and no one has yet been hired to fill the vacant Project Director position, although the Director has indicated that such a person will be hired. We believe these actions are steps in the right direction and will help the Agency to better achieve its objectives.

<u>Review of Assets, Priorities & Resolution Plans</u> - The first two items were completed in the third quarter 1996. As recommended in the June 1996 Quarterly Report, the Workplan was revised to exclude the development or implementation of Asset Resolution Plans. (see quarterly report for discussion)

<u>Review and Evaluation of Board Packages for Form, Content, and Standards</u>- This evaluation required translation of a number of documents from a sample "Board Package", however, due to other priorities, was not accomplished until May-June 1997. Generally, it was found that the Packages were adequate, and that all items considered by the Managing Board were submitted in writing with some documentation. Thus, no further work on this item was considered warranted. An exception, in the Advisors' opinion, is that more analysis should be performed on proposed restructures, but this matter has been covered elsewhere.

<u>Development of Policies and Procedures for the Computer Network-</u> The Agency computer system consists of twelve personal computer work stations, three printers, and a central server. During October1996, a data entry clerk was hired, and memory capacities of computers were upgraded. The individual hired as data entry clerk has a great deal more experience and expertise than the Advisors expected (Advisors usually refer to this individual as an information specialist), and he has implemented a number of positive steps in procedures for computer operations, including documentation of files and reports for use by Project Directors. During the extension period, the Data Entry

Clerk/Information Specialist has developed ad hoc informal policies and procedures. Although these procedures can and probably should be more formalized eventually, the current level of efficiency of the system, quality of 'informal' policies and procedures, and protection of data integrity is considered high. Due to the limited size of the system and effectiveness of controls in place, no further work was considered necessary.

Continued Review of Laws, Agency Results, and Other External and Internal Matters Requiring Modification to Policies and Procedures- The laws and internal policies and procedures were reviewed and recommendations for enhancements provided throughout the technical assistance program. Some additional work may eventually be necessary in the area of policies and procedures for equity sales, but such work has been suspended due to weaknesses in the current law (see discussion in previous quarterly report).

Documentation and Reports

File Documentation and Financial Statement Standards - As discussed in the previous Quarterly Reports, objectives pertaining to file documentation standards have generally not been achieved as desired due to lack of personnel for the size of asset portfolio (see comment under Conclusions, following). We did, however, develop an extensive asset summary form, which has labels in both English and Macedonian. Though this form has not yet been adopted, a derivative similar form was developed by Agency staff for use with a particular common type of loan (denar loans). This document, and other similar ones that will be developed therefrom, should assist in maintaining of continuity when assets must be worked by deputy or successor Project Director assigned to asset, and should also provide a basis for asset analysis and development of asset plans where appropriate.

Testing and refinement of ZPP analytical software continued, with some final minor revisions and additions made during the final quarter. An objective of this software is to convert data from ZPP (central clearing house) reports to a form approximating international accounting standards. (Due to lack of uniformity and an audit function, such standards cannot at present be fully met.) Reports from this software are used to analyze borrower financial condition during the collections and negotiation process. Also, these reports are used extensively in one-on-one training with Project Directors. Project Directors have been given direct access to the software and some training in its use. It appears that all use the software to some extent.

Database Entries, Reports, and Testing - During late 1996, a Data Entry Clerk/Information Specialist was hired; in addition, office network hardware was upgraded. Once the Information Specialist had worked through a number of initial projects and developed reports and other information for the Agency 1996 Annual Report and 1997 Financial Plan, he was able then to develop a database from these files and reports. The primary shortcoming of the database is the lack of reliability of the data provided by the loan servicer, Stopanska Banka. Despite this problem, reports and updated files are produced monthly and information provided is generally adequate in form and content. Included in these reports are Delinquency Reports, which is a task included under the Supplemental Work Plan. Advisors have made some parting suggestions we believe will be helpful in refining the database. The Data Entry Clerk/Information Specialist does, however, appear to be quite capable and will no doubt continue to refine the system without significant prompting.

The Data Entry Clerk/Information Specialist was occupied during his first few months with a number of short-term tasks of immediate concern to Project Directors and Director Hajredini. During the first quarter 1997 (the fifth quarter of this project), most of his time was spent on obtaining and revising data and on producing tables for the Annual Report and Financial Plan. As a result, completion of the database was stalled for several weeks. As of the end of the project, the Data Entry Clerk/Information Specialist was able to provide a wide range of current reports on asset status, delinquency, collections amounts, and other data. Most necessary reports are being provided on a monthly basis, and reports are generally considered sufficient in form and content. The current database is defined as a core file of asset and borrower information, and a number of other files pertaining to payments due and collections. Files utilize both Excel and Access software for maintenance. Though generally adequate in content, the database is not as well-integrated as Advisors, or Agency personnel, would like, primarily due to the many short-comings of the servicer, Stopanska Banka, which provides the data used. A review of the problem by Advisors, and discussions with Agency personnel, has resulted in no plan of resolution, primarily because there appears to be no adequate alternative servicer at this time. The other logical alternative--bringing the servicing in-house--would require technical expertise beyond the scope of this project. In addition, due to the strong resistance to enlarging of government agencies, it appears unlikely that such expansion of staff would be politically permissible. One other potential solution is that Stopanska Banka may be sold, and as a result of the new ownership, such services may be significantly upgraded. The likelihood of this outcome is unknown at this time.

For now, the number and quality of reports appears to be generally adequate, though they are difficult to compile for the reasons cited. It is expected that the Data Entry Clerk/Information Specialist will continue to be instrumental in implementing and improving management reporting systems important for the Agency.

Financial Statement Analysis and ZPP Software- Financial statement standards are important for reliable analysis of borrower financial condition. Though not in conformity with international accounting standards, existing reports provided by companies to ZPP are standardized and can be used for analysis, and the Agency can request additional information on certain specific items for clarification. Software designed by the Advisors provides a translation of ZPP data into forms and reports more useful for borrower analysis/payment trends. This software is important also due to the lack of staffing, since it alleviates much manual work for which Project Directors have little time.

Further significant refinement of this ZPP Analysis software continued, with some final, less critical revisions being performed in the final quarter of the project. The program continued to be used to analyze borrower financial statements for applications in training and in Project Director negotiation with borrowers. Advisors made some significant additions to reports generated by ZPP analytical software.

New reports include full financial reports, for use by BRA staff, and summary reports, for use by the BRA Managing Board, presented also in Macedonian language. Also, Advisors made other revisions to resulting reports and made significant applicable additions to documentation. The software continues to be used in borrower analysis and in one-on-one training of Agency personnel. Though ZPP report data for year-end 1996 is currently available in hard copy from BRA borrowers at present, this data was never made available on disk, which makes manual input of data necessary.

Asset File Standards - Advisors completed an asset summary form - Information on Debtor and Claim, which was submitted for review by the Assistant Director. A very limited form had been previously developed in the Agency and had had some limited use. Advisors expanded and revised the form and have incorporated item identifications in both Macedonian and English languages, so the form is easier for Project Directors and Advisors to use. The purposes of the form are to help provide continuity when responsibility for the asset is reassigned and also to provide a basis for developing asset resolution plans, should the Agency's staffing resources be expanded to allow for this effort. Initial reaction has been a reluctance to use the form due to the extra effort required, but in the most recent quarter, one of the Project Directors developed a version of the form which was simpler and for use with one type of loan. It is anticipated that the modified form will begin to be used by more of the Project Directors.

Training

When initially developed, the Workplan provided for the presentation of formal training courses in seminar and case study format. Though both formats were used early during this project, their results were very limited, primarily due to difficulties in scheduling because of demands on time of Project Directors. At the request of the Director, the Advisors recommended amending the Workplan to provide for more one-on-one training of Project Directors using actual BRA cases, in lieu of the more formal group training envisioned in the original Workplan. (Please refer to the June Quarterly Report for justification of this Workplan revision.) In response to the Director's request, and our concurrence that one-on-one training would be more productive, the Advisors have assisted the Project Directors in various aspects of analysis and development of loan workout strategies on a large number BRA borrowers. Specific details regarding the type of training provided in each case is presented in the Monthly Reports submitted during the project. Additional less-comprehensive training was performed as requested on a number of other borrower cases.

Case problems, examples of actual case studies, and other training materials have been assembled and refined, and are included in the Asset Resolution Manual.

One-on-One Training - During the final quarter of the project, Advisors continued with one-on-one training, with individual Project Directors on actual Agency cases. During the project, the focus of such training was generally financial statement analysis, loan underwriting, and contract negotiation. ZPP analytical software was extensively used as a tool in such training. Approximately fifty cases, generally the largest and most complex loans, have been reviewed comprehensively, and many others have been reviewed on a less extensive basis. Such training has not been uniform in its effect, because some of the Project Directors are more receptive than others. It is our opinion that the most talented and effective of the Project Directors (including the newly promoted Assistant Director) have been the most receptive to the training and have benefited most. These individuals can and have been providing guidance to those less receptive, and such training is expected to continue after the departure of the advisors. Seminar format was used very little during the course of the project because of demands on staff time and the resultant difficulty in scheduling.

Participant Training - During the final quarter of the project, three Project Directors left for USAID-sponsored participant training in the United States. During the course of the project, the Director, Assistant Director, all seven Project Directors, and both Agency attorneys have attended three to four weeks of such participant training. Though there were minor exceptions, the training was considered successful by participants. The most effective methods appeared to be structured classroom training in technical subjects directly related to the participants' current work. Other related subjects were also helpful in giving the participants a broader view of the banking industry. The exposure to professionals and managers in the United States gave the participants a more global perspective on the industry and their work. Although the long staff absences were difficult on the on the understaffed agency, the participants were better able to focus on the training at hand.

Training Documentation - During the course of the project, a number of case problems were developed by Advisors for individual work by Project Directors. These problems featured technical methodology required in loan, equity, and financial statement analyses. Despite being effective teaching tools, these problems were not completed to the extent the Advisors would have liked, despite orders from the Director to do so. The Asset Resolution Manual developed during the final quarter of the project (see discussion in next section) includes a section on Training. This section includes all problems and other training material presented during the project, and answer keys. Talking points were added to the training materials/cases so that the materials could be used as reference in the future. The training materials provide a good basis for training any new Project Directors or current Project Directors in the future as time allows and as needs develop.

Oversight, Asset Management & Disposition Issues

This Task represents the Advisor's on-going responsibility to identify operational issues critical to the Agency's management and disposition of assets and to develop recommendations for improving the BRA's effectiveness in this area. Throughout the contract term, the Advisors have actively assisted the Agency through both formal memoranda and informal discussions regarding the following issues:

- The need to perform more detailed financial analysis and/or obtain relevant information from borrowers prior to entering into negotiations.
- Alternative loan workout strategies involving splitting loans into two notes for the purpose of converting at least part of the debt into a "performing" and "marketable" asset.
- Advantages of re-issuing the BRA bonds in a more marketable form.
- Disadvantages of current BRA interest rate policy on restructured debt.
- Identification of legal constraints to BRA operations and suggested amendments/additions to current law.
- Strategies and procedures for the Agency's sale of loans and equity.
- General guidelines for loan analysis and restructure.
- Defining Agency responsibility for BRA equity in companies in which the Privatization Agency also has responsibility.
- Bankruptcy and legal collection efforts.

- General administrative methods to improve effectiveness of asset management and disposition efforts.

During the final quarter of the project, Advisors were requested to provide recommendations on a new interest rate policy for companies in depressed industries. (see Exhibits - Memorandum of June 19, 1997)

During the final quarter, Advisor was also requested to draft a recommended policy for write-off of all or a portion of loans. The draft, which has been submitted for review by the Assistant Director, included objective criteria for loan classification and write-off, subjective criteria for write-off, and a discussion of pertinent methodology to be used in calculation of write-off amounts. (see Exhibits - Memorandum and Draft of July 28, 1997)

Loan and Equity Sales - At the time of project completion, the Agency had sold one loan and a few equities through sealed bid sales. It had been anticipated that Advisors would be significantly involved in assisting the Agency in preparing for loan sales during the project extension period. As discussed in previous reports, however, very few loans and equities were ever offered for sale, primarily due to the understaffing that affects many of the Agency's operations.

The purpose of these initial sales was to train Project Directors in asset packaging and sales, and also most importantly, to test the market for investor interest in such a product. The initial sales were successful. Although Advisors did have significant input into the process, they were not consulted on certain items, and some missteps occurred, we believe, as a result. Advisors believe the Agency should be more aggressive in offering loans--that is, to offer more loans for sale, and on a regular basis. This recommendation was presented as part of a memorandum dated May 22, 1997. Advisors also recommended more aggressive equity sales, but believe that the law affecting equity sales should be revised, to allow for negotiated sales .

Equity Ownership Balances - As a result of a meeting of the Agency staff with the Privatization Agency, it was discovered that there were some material differences between the data contained in BRA's database and that of the Privatization Agency, particularly with regard to the BRA's percentage ownership in several of these companies. This is an unresolved issue, and we have encouraged Agency staff and management to correct these differences, which need to be resolved before disposition/sale of BRA equity.

Asset Resolution Manual- During the final quarter, Advisors completed an Asset Resolution Manual. (This document is not attached to this report because of its size, but is, however, available at the Agency and in project files of Barents LLC / KPMG.) This manual was compiled from reports, memoranda, computer printouts, software documentation, and training materials developed by Advisors during the course of the project. New additions included the overall structure of the manual, introductions to subject sections, and additions of text (sometimes extensive) where considered warranted to fill gaps in material or for clarifying relationships among various materials. The purpose of this manual is to present Advisors' work product pertaining to asset resolution in a unified and orderly format, for reference by Agency personnel as work problems are encountered and as training needs arise. Sections of the manual include Documentation, Financial Statement Analysis, ZPP Analytical Software (Excel), Training and Study Guide, Example Case Studies, and Appendices. It is the Advisors' intent that this be a living document, and that Agency staff add to and revise this manual as they feel necessary.

Donors and investors - During the course of the project, Advisors had numerous meetings with representatives of the international donor community and with private investment groups. The purpose of these meetings was to provide information on the Macedonian economy and general information on Agency assets. We have encouraged Agency management to try to cultivate investor interest by seeking out such organizations and by developing and providing standardized information packages.

CONCLUSION:

Overall, we accomplished the majority of our objectives as outlined in the workplan. Progress was made and steps were achieved to ensure the successful resolution of problem assets. Achievements, as discussed throughout the program, were somewhat constrained by resource limitations of the Agency. However, a core group of staff and management within the Agency to have gained a better understanding of asset resolution techniques.

The project proceeded in accordance with the timeframes and tasks provided for in the original Task Order/Workplan, except for two areas.

1) The request to eliminate the development of Asset Resolution Plans from Task 1.

2) The inclusion of one-on-one individual training, using actual BRA cases, as a supplement to the formal training provided for in Task 3 of the original Workplan.

As noted in previous reports, although the Advisors have met the targets of the Workplan with the above exceptions, the Agency has been slow to respond in several areas as follows:

1) Response to formal training has been less than desirable as several Project Directors did not complete the Case Study problems developed by the Advisors and distributed by the Director. One-on-one training has been effective with well-motivated Project Directors, but much less so with those who are not. There has been continual incremental progress in rapport with personnel, but overall response has been much less than Advisors would have liked.

2) The Agency has thus far failed to use, or to use extensively, many analytical techniques and loan workout alternatives suggested by the Advisors. In addition, the Agency has an informal policy of not aggressively pursuing legal collection methods. We believe these practices establish a bad precedent and contribute to the Agency's very low collection ratio. Our impression, which is reflected somewhat in the text of the Agency's Annual Report and other documents, is that governmental elements having influence over Agency operations wish to avoid adverse social impact caused from company failures and loss of jobs. Thus, motivation of some Project Directors is undercut by the Agency's overriding policy of reluctance to act aggressively in loan collections. In the opinion of Advisors, most loan restructures still do not incorporate realistic repayment terms and contribute to poor payment histories on recently restructured debt. In addition, while aware of the need for flexibility in a transitional economy, Advisors believe that current collection efforts could be significantly improved and could be more beneficial to the country over time. We acknowledge the need for a middle ground, but we also believe more aggressive collection efforts and better-developed repayment plans would better benefit the government's efforts at transition to a free-market economy.

3) The Agency has yet to adopt any formal organization. A major step in resolving this issue was, however, accomplished in the final project quarter, with the creation of the position of Assistant Director and the appointment of a well-qualified individual. Advisors observations thus far indicate that this action will have a considerable positive effect on Agency organization and operations.

4) We believe the BRA is significantly understaffed, particularly in the number of Project Director positions. Without a major increase in staff, the Agency will not be able to take full advantage of our recommendations in many areas, since these require significantly more effort in asset analysis and in sales of loans and equities.

More recently, Advisors have concluded that other additional aspects of Agency operations should also be reconsidered. During the final quarter of the project, Advisors submitted, at the request of the Agency Director, recommendations for revisions to law and policy affecting the Agency. The recommendations included subjects that Advisors had been presented before in other contexts. Nevertheless, the combined presentation of these items effectively gives a more strategic impression of the current versus the recommended directions for the Agency. Generally, the recommendations call for the Agency to be more thorough in analysis, and more aggressive in collections and loan and equity sales. Though the initial reaction of the Director seemed positive, we do not expect the recommendations to be comprehensively implemented in the near future for the various reasons discussed in previous reports. (see Exhibits - Memorandum of May 22, 1997)

Progress To Date

As previously stated, the Task Order was modified to extend the period of performance through August, 1997. The Benchmarks to be achieved during 1997 are provided below.

March 1997

Policies and Procedures for the computer network/database will be drafted and submitted for review and approval.

__X__Met ___Unmet ____Partially Met

Initial assessment of accounting and payment processing procedures will be completed and recommendations for amendments prepared.

____Met __X__Unmet ____Partially Met

(BRA Director did not desire assistance in this area.)

Laws related to the BRA will be reviewed and if necessary, proposed revisions developed.

__X__Met ___Unmet ____Partially Met

A case load/scheduling process for loan/equity sales will have been developed.

____Met ___Unmet __X__Partially Met

(Loan/Equity sales have not been as frequent as originally projected. Basic techniques were discussed, however, a formal process was not implemented.)

Formats for offering materials and asset packages will have been developed and presented to the BRA for implementation.

__X__Met ___Unmet ____Partially Met

June 1997

Board package standards will have been developed and revised and presented for final approval.

__X__Met ___Unmet ____Partially Met

Database refinement/conversion will be complete.

__X__Met ___Unmet ____Partially Met

Asset file standards will have been developed and presented for adoption.

__X__Met ___Unmet ____Partially Met

Training will have been provided on financial statement analysis, loan workout and negotiation to all asset management staff.

____Met ___Unmet __X__Partially Met

(Training opportunities were provided for all staff members, however, not all participated to the full extent.)

Assistance will have been provided to BRA to ensure the presentation of proposed legislation changes to authorities.

____Met ___Unmet __X__Partially Met
(Provided assistance as requested.)

Guidance and training in asset sales methodologies will have been provided.
__X__Met ___Unmet ____Partially Met

August 1997

Board package standards will have been implemented and training provided.
__X__Met ___Unmet ____Partially Met

Data base conversion and policies and procedures manual will have been finalized and training provided.
__X__Met ___Unmet ____Partially Met

Training seminars will have been provided and future training needs identified.
__X__Met ___Unmet ____Partially Met

Techniques to ensure the continued use of operating policies and procedures as adopted will be discussed with the head of BRA.
__X__Met ___Unmet ____Partially Met

Project Administration

Task Order Data (Bank Supervision and Bank Rehabilitation)

Total Level of Effort	1193 Days
Total Estimated Costs	$1,520,496

a) Cumulative level of effort (as of 5/30/97/):	914 workdays or 77%
b) Unused level of effort:	279 workdays
c) Cumulative expenditures to date:	$1,110,539 or 73%
d) Remaining unexpended balance:	$409,956

APPENDIX

The following documents are attached:

Exhibits

A. Memorandum: Recommended revisions to interest rate policy of BRA
B. Draft Policy: Criteria and Procedures for writing off a portion of loan balances
C. Memorandum: Recommended revisions to Law and policy of BRA
D. Memorandum: Procedures for writing off a portion of a loan balances

EXHIBIT "A"

Final Report

for Project Period Ended July 31, 1997

Macedonia Bank Rehabilitation Agency Assistance

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MEMORANDUM

To: Mr. Gjorgji Nacevski, Senior Project Director
From: Greg Taber, Resident Advisor
Subject: Recommended revisions to interest rate policy of BRA
Date: 19 June, 1997

At the request of the Managing Board and Director Hajredini, you are drafting a revised policy for using a reduced interest rate on certain loan restructures undertaken by the Agency. From our brief discussions, I believe I understand the main points of your proposal. I am in general agreement with your recommendations. Some thoughts from our discussions are as follows:

1. A lower interest rate is to be offered companies in industries which are at present economically depressed, including agriculture, metal-processing, and transportation (trucking). Certain other borrowers may also qualify. The purpose of this program is to increase the likelihood of loan payment to BRA and to increase the amount of debt collected.

2. Most Agency borrowers are not in strong financial condition, but this program is specifically for companies which are likely to survive and can be helped by an interim reduction in rates. Companies excluded from this program are generally those so weak or poorly managed that a reduced interest rate will not help them to survive. These include: those unable to pay taxes and/or pension contributions; those with a large and burdensome obligations to the Privatization Agency; and those with no prospects for future development or survival. Companies should be excluded if: in bankruptcy or if likely to be in bankruptcy in the near future; they have high and/or increasing liabilities for wages; they have chronically failed to pay or to cooperate with the Agency. Another exclusion should probably be loans below a certain size.

3. Borrowers must have demonstrated a willingness to pay. This is most clearly evidenced by a good payment history. Weak companies, however, may have problems paying, and may not have good payment histories. The willingness to pay is very important and difficult to determine. Some questions to ask: Has the borrower made some payments (especially if they have been promised)? Is the borrower responsive? Do officials come to meetings with the Agency? Do they return telephone calls from Project Directors? Are they willing to provided information requested? Are they just dodging the Agency to buy time, or are they making a real effort to pay?

4. Does the company have a formal plan for improving its financial and operating position? Is the plan feasible and likely to be performed? Are new markets being developed? Are costs (both direct and overhead) being reduced?

5. Borrower must provide complete recent financial statements and all other information requested. Borrower must try to answer all questions in good faith. Borrower's accounting practices should provide correct and reliable reports on a regular basis.

6. A thorough financial analysis should be performed by the Project Director. This analysis must demonstrate that the borrower will be able to pay under the restructured loan terms. The analysis should also show that the reduced rate will significantly benefit the borrower's operations. Danger signals include low or negative net worth, increasing or large operating losses, low or negative net working capital, declining sales, increasing liability for wages, growing inventories with no growth in sales, increasing costs or expenses, and weak cash or funds flows.

7. The review of the borrower's financial position should take into account other debt, both at the BRA and with other borrowers. The restructure should not impair the Agency's position among creditors.

8. The restructured payment plan should require regular payments from the start (and should generally not have a grace period). Thus the borrower has discipline to pay and can immediately demonstrate that they will pay.

9. The lower interest rate should be reviewed annually, rather than set for a longer duration. A lower interest rate should be seen as a temporary measure to allow the borrower a chance to improve its operations and overcome market and economic weaknesses. Loan documents should have a provision that if the borrower fails to pay, the lower interest rate will immediately be canceled.

There are other, larger issues which we had discussed having to do with loan collection and Agency policy. Some of these issues were discussed in our previous memo to the Director, which presented recommendations that are more strategic. On the items preceding, I've tried to limit recommendations to those pertaining only to this proposed policy. There are probably a few other points you have thought of that I have not. Please let me know if you would like to discuss this further. I think this program could be helpful to some borrowers if it is used carefully and with the guidelines set out.

EXHIBIT "B"

Final Report

for Project Period Ended July 31, 1997

Macedonia Bank Rehabilitation Agency Assistance

Bank Rehabilitation Agency of the Republic of Macedonia

Criteria and Procedures for writing off a portion of loan balances

According to accounting standards, loan balances carried on the books of the Agency should reflect their correct value. The loan balance is the measure of what the borrower owes to the agency at a given point in time. The amount on the books of the borrower should agree with the amount on the books of the Agency. For various reasons, the loan balance may be overstated, and in that instance should be adjusted to reflect the correct value. Normally this is accomplished by writing off (or reserving for) a portion or all of the loan.

Write off - Reduction in value of an asset, by crediting the asset account (on the Statement of Condition) and debiting a loss or expense account (on the Income Statement). The debit and credit will be in equal amount and will be the amount of the reduction in value.

Reserve - Reduction in value of an asset indirectly, by crediting a reserve or contra-asset account (on the Asset side of the Statement of Condition) and debiting a loss or expense account (on the Income Statement).

A *contra-asset* is an account on the asset side of the balance sheet that normally has a negative (credit) balance. Often this amount offsets a particular asset account.

A write-off and a reserve are two slightly different methods for accomplishing the same thing--reduction in the size of an asset carried on the Agency's books.

The *primary difference* between them is that the *reserve* remains on the Statement of Condition as a record of the amount the asset has been reduced.

Either a write-off or a reserve can be for *all or a portion* of the loan amount, although usually a reserve is not used for the total loan amount.

The *loan balance* carried on the books of the Agency should reflect the likelihood of collectibility --

1) according to the terms of the contract, or if the terms of the contract are not met
2) according to a negotiated settlement, or if such a settlement cannot be agreed
3) from other legal measures, such as foreclosure, bankruptcy, forced settlement.

The *terms of the contract* are defined as the current contract, whether that is the original contract or a subsequent reprogrammed or restructured contract.

Objective criteria for write-off. These are clear criteria, set by Agency policy, that require specific write-off amounts, without the judgment of the Project Director, Agency Director, or Agency Managing Board. These criteria are similar to, or the same as, criteria set by the National Bank for loan classification. Since these criteria are set by policy of the Agency, they can not be overridden except by the Agency Managing Board and in exceptional circumstances.

Subjective criteria for write-off. These criteria may be used to write-off greater amounts than required under objective criteria, or they should be used when objective criteria are not available or do not apply. In rare exceptional cases they may be used by the Agency Managing Board *instead of* objective criteria.

Though these criteria rely on the judgment of Agency staff, they are not arbitrary or totally judgmental. Rather these criteria rely a various applicable and well-defined analytical tools.

Both objective and subjective criteria are discussed in greater detail in the following sections.

Authority for Write-off

Sole authority for the write-off of all or a portion of loan balances is vested in the Managing Board of the Agency. The Managing Board may, however, delegate all or a portion of its authority to the Director of the Agency and/or to Project Directors. Such delegation will be set out in writing, and its approval will be a part of the minutes of the meeting(s) of the Managing Board.

Objective Criteria

Under objective criteria, the Agency will classify each loan according to factors set out following, and will write-off all or a portion of a loan according to amounts set out for each classification.

Loan classification. In this process, Project Directors will present a written recommendation to the Managing Board of the Agency, with adequate documentation that sets out the conditions establishing the particular classification.

1) Category A (high quality) - Claims paid when due or with no more than a 15-day delay; fully secured by money assets or securities of Republic of Macedonia.

2) Category B (good quality, but with some weakness) - Claims paid with a delay of 15 to 60 days.

3) Category C (significant weaknesses) - Claims paid with a delay of 61 to 150 days; or weaknesses in documentation or repayment sources.

4) Category D (some expected losses) - Claims paid with a delay of 151 to 365 days; or where bankruptcy or forced settlement has been proposed.

5) Category E (extremely doubtful) - Claims not paid, or paid at greater than 365 days; or borrower in bankruptcy or liquidation.

All or a portion of loans will be written-off according to the following amounts:

1) Category A - 0% written off
2) Category B - 10% written off
3) Category C - 25% written off
4) Category D - 50% written off
5) Category E - 100% written off

Subjective Criteria

Under subjective criteria, the Agency may either 1) classify a loan A, B, C, D, or E, and write-off all or a portion of the loan according to amounts shown preceding, or 2) set a specific write-off amount based on calculations and judgment according to factors set out following, without a specific classification.

In classifying loans, Agency personnel must consider the following criteria: 1) capital adequacy of the borrower; 2) cash flow from borrower's operations; 3) character of the borrower, as reflected in the borrower's payment history and willingness to comply with requests from the Agency; 4) collateral that secures Agency debt; 5) conditions of the borrower's operation, including other credit outstanding, profitability, prospects for the future, and overall economic conditions and their effect on the borrower.

Subjective Criteria - Methods for Calculating Write-off Amounts

Submarket contract terms. In these instances the loan is likely to be repaid, in the judgment of the Project Director and based on the loan's past performance and other analysis performed by the Project Director. The loan interest rate or other terms are, however, below (more favorable to the borrower) that offered in the market. Thus, even though all principal and interest are expected to be repaid, their amounts are less than what a lender or similar investor would receive for such an investment of funds in the market.

The basic methodology for calculating the write-off amount in this instance uses present value theory and discounted cash flows. The process is in two parts: 1) estimate what the actual contract cash flows are to be over time, and 2) discount these cash flows to their present value using a *market interest rate*. This present value amount will be the correct loan balance, to which the current loan balance should be reduced.

For most contracts, the first step will be relatively clear, since payments and their timings should be set out in the contract. Some estimation or calculation of interest amounts may be necessary. The second step requires some judgment in selecting what the market interest rate is. The type of loan and risk of repayment are important factors in selecting a market rate.

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A complete discussion of all factors to be considered and all methods to be used is too lengthy and technical to be included here. A demonstration of various technical methods used in calculating loan value with submarket interest rate are shown in the Agency *Asset Resolution Manual* in the section on Training for the subjects of Net Present Value and Discounted Cash Flow.

Appraisal of Security Property. This criterion applies when the loan is not likely to be repaid fully *and* the loan is secured by a mortgage or other instrument. Though occuring less often, this criterion also applies to assets acquired in bankruptcy or forced or agreed settlement. In this instance, the loan is repaid by the Agency foreclosing or otherwise acquiring the security asset and then selling it. The correct loan amount to be carried on the Agency's books would thus be the value of the security asset, less any costs of acquisition and sale. Such assets may include real estate (land and buildings), equipment, inventories, or receivables.

For real estate and certain other assets, such as equipment and inventory items, a formal written appraisal report is required. The appraisal should be of sufficient quality for its purpose and should conform to standards of the profession, which usually include the following:

1) *Effective date* of appraisal - Value is dependent upon time, and the appraisal report must set out a *specific date for the value estimate*. For real estate and major equipment items, the appraisal should normally be no older than six months, or its value estimate should be recertified by the appraiser, and any changes in value fully documented. If there are recent market changes, a currency devaluation, or other similar factors that may have affected the value of the asset, the value estimate or recertification must take into account such changes.

2) *Appraiser* - The person responsible for the report should have adequate professional education and experience in appraising the applicable property type. The appraiser should be approved by the Agency Managing Board. Herein, the term appraiser refers to a natural person and will include one or more persons who made significant contributions to the appraisal report.

3) *Appraisal methodology* - The value estimate of the report must be supported by market information and professionally accepted methodology. All pertinent information and methodology must be clearly set out in the written report. The appraisal will normally include three approaches to value: a) the cost of the asset in its current condition, b) a comparison of recent actual sales of similar assets, and c) an analysis of the income generated by the asset (for instance, rental income less expenses for real estate). The indications of value estimated by these three approaches must then be reconciled for any differences into a single estimate of value. These are *minimum* standards, and the amount and complexity of documentation will vary according to the size and complexity of the asset(s) being appraised.

The appraisal report must be *reviewed and approved* in writing by the Project Director. If the Project Director concludes that the appraisal does not meet standards set out preceding, he or she must return the report to the appraiser with a memorandum setting out criticisms and objections. The value estimate given in the appraisal report must not be accepted or used, until all objections are resolved, and the appraisal is approved by the Project Director.

For smaller assets, such as furniture, fixtures and equipment; inventories; and receivables, a value estimate from an expert may be obtained by the Project Director. Because these assets are smaller and/or simpler, the standards for estimating their value will not be as complicated. To be used by the Agency, however, these reports must 1) be in writing, 2) be prepared as of a recent effective date, 3) be prepared by an expert knowledgable of the type of asset and its market, and 4) use adequate methodology and contain adequate supporting documentation according to the asset's size and complexity.

Appraisal of the borrowing company. This criterion applies when the loan is unlikely to be repaid according to the contract, *and* when the loan is not secured by any asset. Normally, this criterion applies in instances of bankruptcy, forced settlement, or negotiated settlement. In these cases, the Agency is paid from the liquidation of the company's assets, and the amount the Agency receives is according to various factors, including its pro rata share of debt, priorities of debt, and whether any of the other debt is secured. As with real estate appraisals, this appraisal should be as of a specific date, be prepared by an appraiser having sufficient experience and qualifications, and should conform to professional standards for documentation and methodology. The appraisal should be reviewed and approved by the Project Director, who should recommend to the Managing Board of the Agency the amount of write-off indicated by the appraisal, along with a discussion in support of the recommended amount.

Other analysis. In many, or perhaps most, instances, Agency loans will not be secured, and there will exist no appraisal for the borrowing company. Therefore, the Project Director will need to determine the likelihood of loan repayment by means of estimating company *cash flows* available for payment of the debt. This process includes many procedures and techniques, which are discussed more completely in the Agency *Asset Resolution Manual*, in memoranda provided by the Resident Advisors, and in analyses performed on various individual companies as one-on-one training with Project Directors.

The following items are a summary--for more detailed guidelines, Project Directors should refer to memoranda and other materials discussed preceding. Analysis of financial statements generally has the following steps:

1) *Collection and checking* of data for correctness. Financial statements for the last two or three years should be obtained. The form of these statements will normally be ZPP reports, but any other detailed format that conforms to Western accounting standards is acceptable. The Project Director should then verify that information is correct, and should request revisions or clarification where warranted.

2) *Review and analysis* of financial information. This step includes review of financial ratios, changes over time, and review and analysis of major items. This process requires much interaction with the borrower, as the Project Director requests additional information and asks questions about various line items that are not readily explained. Much of this step will probably use ZPP reports of the company and Agency ZPP analytical software.

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3) *Total company cash flow.* development of *historic* cash flows for the company; *forecast* of likely future cash flows; normal operations and any known or expected changes that may occur.

4) *Cash flow available for Agency debt.* Normally, the borrowing company will have debt to other companies or entities besides the Agency. Debt service to the Agency may be on a pro rata basis, according to its ratio of total debt, and will also take into account such factors as legal priority of claims of the Agency and other debtors. Typically, if the borrowing company must reduce its loan payment amounts because cash flows are inadequate, a new contract should be negotiated with the Agency.

5) *Write-off* of all or a portion of loan balance. The loan balance on the Agency books should be the present value of the likely loan payments to be received. If these payments are lower than the original contract, it is likely that a portion of the loan balance must be written off to reduce the loan balance to the correct amount.

EXHIBIT "C"

Final Report

for Project Period Ended July 31, 1997

Macedonia Bank Rehabilitation Agency Assistance

MEMORANDUM

To: Mr. Dzevdet Hajredini, Director
Ms. Rozika Bojadzieva, Project Director
From: Greg Taber and Alan Hawkins, Resident Advisors
Subject: Recommended revisions to law and policy of BRA
Date: 22 May, 1997

In response to your request, we have the following recommendations for revisions in the law and policy of the Bank Rehabilitation Agency. We have restricted our recommendations to the broader scope of these two subjects, and we have excluded other items which we think do not apply here. We have presented some of the following recommendations before, and some are also similar to, or the same as, recommendations that you already intend to present to your Managing Board. At your request, we have been brief in stating and discussing each recommendation. Further development of detailed proposals can be made upon the approval and request of the Agency's Managing Board.

Collection policies and bankruptcy. One of the Agency's primary goals is the collection of debt. As set out in the Agency's annual report and other documents, a constraint on this goal has been social responsibility, as exercised in decisions by the Managing Board. Debtor companies provide jobs for workers, and if all these companies stopped operating because of bankruptcy or liquidation, the cost of resulting social benefits (welfare, severance pay, unemployment compensation) would be very high for the government. The law for the formation of the Agency, however, does not appear to include any provision to empower the Agency to take such matters into account. In addition, because the Agency does not at present use bankruptcy and other aggressive collection methods for collection of debt, the borrowers have little incentive to pay what they owe. Since most companies are socially- and/or state-owned, with no outside supervision, the likelihood of vandalism, theft, and other erosion of assets is great. In addition, many insolvent companies are already unable to pay workers, so that there is no social benefit from keeping them open.

Therefore, we recommend that the Agency be allowed to use bankruptcy and other strong collection methods in instances that are appropriate. The use of such methods should normally be approved by the Managing Board. In order to implement this policy in an orderly manner, we recommend that the Agency develop an organized program for loan classification and collection. The advisors are ready and willing to assist in the development of such a program.

Loan restructure terms.

General. Negotiating and setting terms for a restructured loan is a difficult process. The Agency should try to collect the maximum amount of payment on loans, but if terms are too strict or difficult, the borrower will not be able to pay. Therefore it is important that Project Directors perform a thorough analysis of borrower financial condition in each case. Also, the Agency should have adequate flexibility in the loan terms it can negotiate.

Paris Club and Zurich Club Loans. At present, these loans are at rates and terms set by law and contract. (Though Zurich Club loans are unaffected at present, we expect their servicing to be similar to that of the Paris Club, in the future.) Many of these debtors are weak, and some also owe denar loans, which may have been restructured. We recommend that the Agency be given the same latitude in restructure terms for these loans as it has with denar loans. We believe it is counterproductive to structure loans under terms which the borrower cannot be expected to pay.

Interest Rate. The current rate which the BRA must use to restructure loans is significantly below the market rate. With such a favorable rate, borrowers have much less incentive to pay off the Agency, and will often pay other debt first. In addition, less income is being collected for the budget. We therefore recommend that the Agency charge rates at or near market rates when restructuring loans. An exception to this practice would be when it is appropriate to split the loan into two separate notes, one at market-rate and one at below-market rates. Please refer to our previous memo, dated June 27, 1996.

Discounts for cash payment. The Agency routinely gives discounts for cash settlement of debt. We believe the Agency should encourage such settlements, in order to resolve such debt and remove it from Agency books. But it seems that the discounts offered, often as a matter of policy, are arbitrary and may be too high. (Though it is also possible some discounts could be too low, since borrower financial condition is often not clear.) We recommend that the Agency develop an internal (unpublished) policy regarding cash discounts, and that such discounts be based on the borrower's ability to pay and the Agency's other alternatives for collection. We also recommend that no discounts be given for payment in frozen foreign exchange deposits, since the market price of such funds is already deeply discounted.

Organization of agency

Agency's term of existence. We understand and agree with the government's intention to limit its size. Last year the Agency collected about US$13.4 million (at an exchange rate of 40 denars to US$1) against a cost of only about US$0.7 million, which means that the Agency's operations resulted in a significant net gain to the budget of the republic. Therefore, we recommend that the Agency's existence continue so long as it provides a significant net positive return. Since some of the collections would occur whether or not there is an Agency or collection effort, the minimum required return should be a level determined by the Managing Board. Also, outstanding debt will eventually be reduced enough that servicing by a separate agency will no longer be necessary.

Agency staffing. As discussed preceding, the Agency provides a net positive inflow to the budget of the republic. We believe that collections could be higher if more staff were added and trained. We therefore recommend an increase in Agency professional staff to meet the demands and objectives of the Agency. The number of persons that would need to be added, and their job descriptions, will be difficult to determine. Because of their experience in similar types of organizations, Advisors would be ready and willing to assist in planning and implementing such an increase in staff size.

Agency structure. At present, virtually all Agency employees report to Director Hajredini. In addition, the Director has significant responsibilities to the Managing Board. We therefore recommend that the Agency adopt our organizational plan, as presented in the memo dated April 8, 1996, which provides for delegation of authority and more clearly defined duties among employees (the expert service).

Loan servicing. According to the Agency's annual report for 1996, the cost of loan servicing by Stopanska Banka is about equal to the Agency's internal operating expenses. In addition, reports are difficult to obtain, inconsistent, and often unreliable. We therefore recommend that the Agency aggressively review other alternatives, such as using a different servicer, or moving the servicing function in-house. (It is possible that this conversion could be assisted and partially funded as technical assistance from one of the aid donor organizations.)

Loan sales. Due to the many problems with restructuring, collections, and servicing loans, we believe that the best means of resolving most loans is to sell them. Yet only recently have any loans (two at this time) been offered for sale, in part due to the many demands on the time of the persons responsible. Therefore, we recommend that the Agency aggressively pursue the sale of loans. As a part of this plan, objectives should be set that include the number of loans (or amount) and dates for sale. It is quite likely that some restructuring of the Agency would be necessary so that certain personnel could focus on loan sales without significant distraction from other duties.

Law on equity sales. Due to law and also to BRA restructure policy, the Agency has acquired equity interests in the loss-making companies, as well as others. In addition, Agency staff has neither the time nor the expertise to manage companies in a wide range of businesses. The law that sets out rules for sale of such equity contains a number of inconsistencies and other shortcomings that make it very difficult for the Agency to dispose of these burdensome assets. We recommend that the Agency develop and submit a comprehensive revision of this law. This document would address various issues that have been discussed by the Advisors and Agency personnel, including valuation and adjustments, minimum sales price, and negotiated sales.

MEMORANDUM

To: Director Hajredini
Ms. Bojadzieva
From: Taber and Hawkins
Date: 22 May, 1997

BRA bonds. At present, BRA bonds are bearer bonds, which causes a number of problems, including security and cumbersome servicing. We recommend that such bonds be converted to registered form at the Agency's earliest convenience. Please refer to our memo dated September 17, 1996, which discusses this recommendation in greater detail. This recommendation would require a change in the BRA Law.

EXHIBIT "D"

Final Report

for Project Period Ended July 31, 1997

Macedonia Bank Rehabilitation Agency Assistance

MEMORANDUM

To: Mr. Gjorgji Nacevski, Assistant Director
Bank Rehabilitation Agency

From: Greg Taber, Resident Advisor
Barents LLC/USAID

Subject: Criteria and procedures for writing off a portion of loan balances

Date: July 28, 1997

Attached for your review is a draft of the referenced procedures, which you had requested. The objective criteria are based mostly on the loan classification criteria at the National Bank. (Published Decision on classification of on- and off-balance-sheet asset items of banks and savings houses according to their risk level.) Subjective criteria are also taken from the same source, but I have made revisions and have added a section on methodology for calculating write-off amounts. This last section is not considered to be comprehensive, but is only basic guidelines, which should be set out more completely in the written policies and procedures of the Agency.

This draft contains my essential recommendations for the Agency, but it is only an initial effort. There are many factors pertaining to Agency objectives and operations that should be taken into account. Please feel free to discuss with me your thoughts as to any revisions or modifications you think are warranted.