Evaluation of BSTDB's Medium Term Strategy and Business Plan 2015-2018

1. Introduction

The Board of Directors requested the Evaluation Office to prepare an independent report on the implementation performance and continued relevance of the Bank's Medium Term Strategy and Business Plan 2015-2018 (MTSBP). This evaluation was conducted to ensure both accountability and learning from past performance, to support an informed further strategy, based on evidence and lessons learned. The evaluation distills and analyzes lessons learned through the implementation of Strategy 2018, reflecting the existing and emerging development challenges of the Bank's shareholders, as well as the key findings of all evaluation overviews performed in the last 4 years.

2. Implementation of key MTSBP targets

The evaluation finds that the Bank has aligned its MTSBP and most operations with Strategy 2020.

2.1. Ambitious portfolio growth of 7.5% p.a.

This target per se is considered ambitious as it is generally higher than previously sustained growth rates. Since 2009, the Bank's average growth was 5.7%. Based on the MTSBP mid-term review, the aimed (and achieved) growth peaked to a record high level of 9% in 2016.

During 2015-2017, BSTDB exceeded its annual base case targets for Board approvals and signings of new operations. The (revised in 2016) cumulative 2015-2018 targets for both BoD approvals and signings were exceeded substantially – at 142.9% and 151.7% respectively.

The increased pace of processing and approving of new/larger operations, including a substantial number of syndications and corporate bond participations resulted in higher, often front-loaded disbursements, that exceeded substantially the MTSBP annual approval targets. This was however offset by a wave of repayments, pushing repayment levels well beyond the MTSBP projections (146.2%), thus shrinking the actual active (outstanding) portfolio below the levels of signings but within the MTSBP target (103.4%). Several factors caused the unexpected prepayments: (i) a sustained decline in interest rates, triggering incentives to refinancing the BSTDB loans; (ii) a policy of some countries towards reducing exposure to external borrowing; (iii) the inability of the Bank to promptly offer better terms and/or re-negotiate prepaid loans, mostly as a result of increased borrowing cost associated with the 500 million USD benchmark bond issued by BSTDB in 2016. Consequently, the Bank's responded with substitution by large scale front-loaded disbursement operations, to offset the decline in the outstanding portfolio.

The combined effect of unanticipated prepayments and the appreciation of the US dollar relative to the Euro resulted in a below-target outstanding portfolio. The response of the Bank was to further increase new operational activity, often re-focusing on larger and promptly disbursing operations. Despite the response-driven impressive exceeding of approval and signing targets, the Bank was unable to prevent a relative decline in its *outstanding* portfolio.

The Bank's inability to grow its outstanding portfolio in line with the aggressive increase in approvals is mainly due to the prevalence of the approval targets, backed by the assumption that more commitments will bring a growth of the outstanding component. However, the actual focus on approvals, and the lack of quality-based cascading of institutional Key Performance Indicators, caused a displacement effect – new operations were quickly displacing existing active operations as the relative devotion to portfolio maintenance was insufficient.

Table 1: Quantitative targets and results

Millions of Euros	*2015*	*2016*	*2017*	*2018*	*Cumulative*	*% Actual/ Target*
MTSBP Target for Outstanding	€1,056.0	€1,200.0	€1,280.0	€1,322.0		
End of Year Actual Outstanding	€1,113.4	€1,191.8	€1,166.4	€1,367.0		
Surplus/ Shortfall BP vs. Actual	€57.4	-€8.2	-€113.6	€45.0		103.4%
MTSBP Target for BoD Approvals	€304.0	€326.0	€376.0	€404.0	€1,410.0	
Actual BoD Approvals	€487.2	€433.3	€524.6	€569.7	€2,014.8	
Surplus/ Shortfall BP vs. Actual	€183.2	€107.3	€148.6	€165.7		142.9%
MTSBP Target for Signings	€266.0	€286.0	€329.0	€353.0	€1,234.0	
Actual Signings	€480.3	€373.2	€400.7	€617.9	€1,872.1	
Surplus/ Shortfall BP vs. Actual	€214.3	€87.2	€71.7	€15.2		151.7%
MTSBP Target for New Disbursements	€296.0	€309.0	€296.0	€299.0	€1,200.0	
Actual New Disbursements	€378.8	€454.5	€393.8	€302.0	€1,800.9	
Surplus/ Shortfall BP vs. Actual	€82.8	€145.5	€97.8	€3.0		150.1%
MTSBP Target for Repayments	€180.0	€231.0	€233.0	€248.0	€892.0	
Actual Repayments	€221.7	€383.1	€316.3	€382.7	€1,303.8	
Surplus/ Shortfall BP vs. Actual	€41.7	€152.1	€83.3	€1.0		146.2%

Notes: Targets for 2015-16 based on MTSBP 2015-18; Targets for 2017-18 based on Mid-Term Review; Data for 2018 may be subject to minor changes based on fair valuation of equity investments; A positive figure in surplus/ shortfall row means target was exceeded; A negative figure means target was not met; Percentages in last column compare cumulative actual to cumulative target.

2.2. Diversify portfolio by country and sector – considerable progress, some disparity remains

The strategy aimed at reduced country concentration, a share of non-Bank operations of at least 55% as well as increase the share of sovereign and public sector operations to 20% of the portfolio by the end 2018.

While the Bank made substantial progress in achieving a better geographical balance, it came short in eliminating large portfolio disparities across countries. The quantitative country targets of the MTSBP 2015-18 and the Country Strategies were exceeded in nine of the eleven shareholder countries. In five countries the signings targets were exceeded by over 50%.

Table 2: Targeted and actual portfolio shares by country (EUR million)

	Signings Target 2015-18 Euros Million	Actual Signings 2015-18 Euros Million	% of Signings Target Met
Albania	67.9	35.8	52.7%
Armenia	67.9	86.0	126.7%
Azerbaijan	123.4	91.1	73.8%
Bulgaria	135.7	206.0	151.8%
Georgia	49.4	150.8	305.6%
Greece	160.4	265.6	165.6%
Moldova	37.0	47.5	128.3%
Romania	148.1	174.8	118.0%
Russia	197.4	248.6	125.9%
Turkey	197.4	433.1	219.4%
Ukraine	49.4	132.9	269.2%
Totals	1,234.0	1,872.1	151.7%

Note: A figure above (below) 100% means the target was exceeded (not met); Targets for 2015-16 based on MTSBP 2015-18; Targets for 2017-18 based on Mid-Term Review; Data for 2018 may be subject to minor changes based on fair valuation of equity investments.

In contrast, in two countries the targets were not met by a substantial margin – Albania (52.7% of target met) and Azerbaijan (73.8%).

Financial institutions stand out representing one third of Board approvals and signings in 2015-2018. The other key sectors are distributed relatively evenly among consumer staples, health sector, energy, industrials, materials, and utilities.

While the Bank consistently paid attention to the (revised downward at mid-term) original target of 20% share of public sector operations, it came short in reaching it. The two underlying reasons for this shortcoming are (i) the insufficient price competitiveness relative to AAA-rated MDBs who offer public sector lending at flat low rates, as well as (ii) the limited experience and capacity of the Bank to structure deals in the public and quasi-sovereign domain.

Private sector operations comprise over 85% of the outstanding portfolio (versus 95% at end 2014).

The average size of operations grew significantly in the 2015-2018 period. New signed operations averaged €20.1 million, about 94% larger than the average size of €10.4 million between 2011-2014. This reflects the focus on volumes and approvals that in turn caused a relative shrinking of the *outstanding* share of the portfolio, addressed above. The volumetric priority also caused a relative erosion of the development profile, as addressed further.

2.3. Portfolio quality

The MTSBP addressed portfolio quality through a single key performance indicator. It states that the positively rated operations upon independent ex-post evaluation should be at least 70% at any given year. As this is a complex composite indicator, involving measurement time-lags

(5-year moving average, reflecting operations maturity dynamics), its actual value will be measured and presented during the next strategy period. However, the data from the last 4 years indicate a stagnating and even deteriorating development performance of the new additions to the portfolio.

Table 4: Independent ex-post evaluation ratings of completed operations

Criterion / Period	Prior MTSBP 2015-2018		Within MTSBP 2015-2018		Comment / Recommendation
Positive ex-post ratings	**2010-2014**	**2012-2016**	**2013-2017**	**2014-2018**	
Relevance	73%	72%	71%	70%	trend setting ex-ante forward indicator, at margins, revisit
Effectiveness	74%	73%	74%	73%	Adequate, but modest ex-ante targets
Efficiency	56%	58%	57%	56%	scale-driven, capital-cost constrained, substandard
Sustainability	58%	60%	61%	57%	constrained by focus on volumes
Institutional Development Impact	57%	58%	52%	51%	as above, high potential
Overall (MTSBP target: 70% or more)	72%	71%	71%	70%	just on target, relevance-sensitive
Ex-ante/ex-post alignment	62%	66%	67%	67%	higher ex-ante / monitoring rigor/incentives needed to reach 90% (MDB standard)
Mandate-based selectivity share	61%	62%	59%	58%	as above

While overall performance increased over the years, the share of operations rated excellent at ex-post has declined from 17% in the early years to 6% during latest periods. This merits attention as highly successful operations are a benchmarking source of valuable learning, motivation and replication. The diminishing cases of excellently rated operations reflect a combination of unrealistic expectations (ex-ante mandate compliance optimism driven by efforts to obtain approval) and lower actual achievement. There are several cases which imply that a closer alignment of operations with country analysis/strategies tends to deliver a higher number of outstanding performance, both at operational and institutional planes.

The two most frequent key causes of mandate-related underperformance are: (i) risks identified at due diligence that were not covered by adequate covenants and/or monitoring; (ii) mitigating the risk of poor corporate governance is very challenging, particularly when not done at the outset of operation handling.

While since 2008 BSTDB maintains its performance generally in line with peer institutions, the Bank lags in the areas of ex-ante indicators setting/tracking, as well as in certain self-evaluations. Returning to mandate compliance growth requires revisiting of indicator cascading/balance in order to offset shortfalls, such as volume-dominated incentives, as well as related waves of premature cancellations and pre-payments.

Contrary to certain prejudice, development performance is positively co-related to general portfolio quality and financial outcomes.

2.4. Institutional developments

The MTSBP 2015-2018 focused on the following institutional enhancements, aiming at becoming a recognized regional Multilateral Development Bank of high relevance and impact:

- **Membership expansion:** Although BSTDB does not control the decision making process, it recognized the benefit of scope enlargement, seeking to attract an AAA-rated institutional shareholder as well as another country from the region. While there is evidence of maintained efforts, this target has not been reached, although there are some prospects.

- **Enhanced institutional recognition:** The focus was placed at enhanced recognition by the Basel Committee, as well as certifications and/or accreditation for participation in global or regional initiatives that are consistent with the Bank’s mandate. Certain success, resulting from a pro-active engagement of the Bank, has been noted in the light of the recent risk-weight reduction by Basel regarding A-rated Multilateral Development Banks (from 50 to 30%). While the gap with AAA-rated institutions is disproportionately high, this is a long-awaited sign of recognition.

  BSTDB has also become a recognized partner of well-established peers, with a particular focus on ex-post evaluation standards and indicator harmonization. In 2018 it led major international events on ex-post evaluations and ex-ante indicators. As of November 2018 it chairs the Evaluation Cooperation Group of the Multilateral Development Banks, for a first time ever.

  The launch of a 500 million USD benchmark bond on the international markets is another example of institutional maturity and recognition, as it raised awareness and build track record of institutional borrowing.

- **Enhanced shareholder support:** Substantial progress was made in view of resolving long-pending capital arrears.

3. Lessons learned and conclusions

The predominant focus on volumes alone, particularly at departmental indicators level, erodes mandate relevance of certain large scale operations, undermining future compliance with the higher mandate institutional goals and profile. While the MTSBP 2015-2018 set an approval growth of 7.5% that turned hard to sustain at the *outstanding* portfolio level. The Bank’ response was to further maximize new approvals and commitments, but this overshadowed the development mandate indicators and screening, as evident by ex-post evaluations on operations *relevance*. Despite improvements in recent years, the success rates of completed projects in several aspects were lower than the benchmarks. This calls for enhancing of institutional relevance and effectiveness on the basis of improved indicator-based selectivity (addressing the principle of financial and non-financial additionality, among other core criteria) and better ex-ante anchoring, implying rigorous application of relevant knowledge, standards, skills, incentives and business processes. Volume-dominated incentives often trigger premature cancellations and pre-payments, as well as substandard mandate compliance.

Ex-post evaluation evidence suggests that development performance is positively co-related to general portfolio quality and financial outcomes. Decline in efficiency typically goes in line with stagnating share or volatility of outstanding portfolio, as well as substandard mandate fulfillment.

The efforts towards institutional improvements and recognition were in most cases successful, elevating the international profile and leverage capability of BSTDB. Examples of immediate advantages include but are not limited to the ability to raise funding and standards of high impact and ex-post evaluation. The Bank should maintain the momentum and build upon the progress made, towards further partnerships and mobilization of finance for its region and mandate.

Despite the efforts to reach the 20% target of public sector share in portfolio, the Bank was constrained by the challenge of funding costs, as well as the need for specific experience and capacity. This target was based on certain underlying assumptions that did not materialize, e.g. attracting a highly rated shareholder.

On a number of occasions the Bank enhanced its relevance and risk sharing by an effort to become more responsive to clients. A good example is the increase in local currency finance that turned particularly valuable to non-exporting borrowers, as their currency risk exposure was better mitigated. While this trend could be encouraged, the evaluation notes its limitations, based on the risk absorption and fund-raising constraints.

Soon after the influx of liquidity, resulting from the issue of the benchmark bond in 2016, the Bank took course in blending its treasury and mandate operations, to make best use of available resources. The rationale was to engage idle liquidity on a temporary basis, with a focus on short term trade finance, to maintain a coherent asset-liability management. With due respect to this rationale, the ex-post evaluation reveals a trend of revolving of what was intended as a short term trade finance lending, at rather low margins. Temporary asset-liability management solutions should not displace development-driven portfolio structuring, as this erodes the Bank’s efficiency and additionality.