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FOR RECONSTRUCTION AND DEVELOPMENT

BACKGROUND MATERIAL ON
CAPITAL RESOURCES REVIEW 4
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CAPITAL RESOURCES REVIEW 4

LIST OF ABBREVIATIONS

ABV	Annual Business Volume
ADB	Asian Development Bank
AEOR	Annual Evaluation Overview Report
AFDB	African Development Bank
ATC	Assessment of Transition Challenges
BIS	Bank for International Settlements
CIS	Commonwealth of Independent States
CEFTA	Central European Free Trade Agreement
COP	United Nations Framework Convention on Climate Change
CPRs	Civil Procedure Rules
CSU	Consultants Services Unit
DAC	Development Assistance Committee
DCB	Depository Credit Banks
DIF	Direct Investment Facility
DLF	Direct Lending Facility
5E Initiative	Energy Efficiency and Environment in Eastern Europe Partnership
EIB	European Investment Bank
ELENA	European Legal Network on Asylum
ENTSO	European Network of Transmission System Operators
ESCO	Energy Service Company
ETC	Early Transition Countries
ETCI	Early Transition Countries Initiative
EU	European Union
EU-15	Original European Union (before accession)
EURIBOR	Euro Interbank Offered Rate
FAO	Food and Agriculture Organization
FIAC	Foreign Investment Advisory Committee
FLAG	Fund for Local Authorities and Governments
GDP	Gross Domestic Product
GIS	Green Investment Scheme
IADB	Inter-American Development Bank
IAS	International Accounting Standard
IBRD	International Bank for Reconstruction and Development
ICT	Institutional Capacity Programmes
IDA	International Development Association
IFC	International Finance Corporation
IFI	International Financial Institution
IFRS	International Financial Reporting Standards
IMF	International Monetary Fund
IPO	Initial Public Offering
IRR	Internal Rate of Return
ISO	Industrial Standard Organisation
JICA	Japan International Cooperation Agency
KEGOC	Kazakhstan Electricity Grid Operating Company
LEF	Local Enterprise Facility
MCFF	Medium-Sized Cofinancing Facility
MDB	Multilateral Development Bank
MSME	Micro Small and Medium Sized Enterprises
NAK	Naftogaz Ukraine
NIA	Net Income Allocation
NIPAC	National IPA Coordinators
NOAG	Net Operating Assets Growth

NPL	Non Performing Loans
OCB	Organisational Capacity Building
OCU	Official Co-financing Unit
ODA	Overseas Development Aid
OECD	Organisation for Economic Co-operation and Development
OFCU	Operational, Financial and Capital Utilisation
OPER	Operation Performance Evaluation Review
PIP	Public Information Policy
PPP	Public Private Partnership
RES	Renewable Energy Systems
RUSNANO	Russian Corporation for Nanotechnologies
SCN	Shareholder Capital Note
SEAP	Sustainable Energy Action Plan
SEFF	Sustainable Energy Financing Facility
SEI	Sustainable Energy Initiative
SME	Small and Medium Sized Enterprises
SOF	Strategic Operations Framework
SSF	Shareholder Special Fund
TAM/BAS	Turn Around Management/Business Advisory Services
TC	Technical cooperation
TCFP	Technical Cooperation Funds Programme
TFP	Trade Facilitation Programme
TIMS	Transition Impact Monitoring System
TIR	Transition Impact Retrospective
UNFCCC	UN Framework Convention on Climate Change
VEB	Vnesheconombank (Russian Development Bank)
WB	Western Balkans Initiative
WSIS	World Summit on the Information Society
WTO	World Trade Organisation

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1. INTRODUCTION

1.1 Background

Article 5.3 of the Agreement Establishing the Bank (the 'Agreement') stipulates that the Board of Governors shall review the capital stock of the Bank at intervals of not more than five years.

In line with this stipulation, the first Capital Resources Review (CRR1) was approved at the Annual Meeting in Sofia in April 1996. The second and third Capital Resources Reviews (CRR2 and CRR3) were approved by the Board of Governors respectively at the 2001 and 2006 Annual Meetings in London.

The preparation of the fourth Capital Resources Review (CRR4) has been advanced by one year relative to previous practice. This decision is in line with the Agreement and reflects the responsiveness of the EBRD both in the short term relative to the crisis and in the medium term by rapidly defining its strategy taking account of the significant impact the crisis is having on its region of operations. The advancing of the CRR4 by one year will also allow for the first time the Bank to start a new CRR period with a formally approved medium term strategy. Until now, the formal approval of the CRR was made during the second quarter of the first year of the new CRR period.

CRR1 was completed in 1995 in response to a request by Governors to examine the capital base of the Bank taking account of the transition financing requirements of the region and of the resulting projected portfolio expansion. Main conclusions included:

- a confirmation of the medium term operational priorities endorsed by the Bank's shareholders in 1994 ;
- an assessment of rising demand for Bank financing in the countries of operations which could not be covered by the available capital;
- a positive evaluation of the ability of the Bank to implement its mandate through its quantitative and qualitative contributions to the transition process;
- an examination of the progress achieved in placing the Bank on a path of sustainable profitability; and
- the rationale and specific proposals for a doubling of the authorised capital of the Bank.

CRR2 was prepared during 2000 as the Bank was managing the impact of a major shock on its portfolio and finances following the events of 1998 in Russia and international financial markets. This impact included a significant financial loss resulting in negative reserves, a sharp rise of non-performing assets and a decline of annual business volume of 9% between 1998 and 1999. CRR2 focused on the implementation of the medium term operational priorities which were reviewed to reflect the lessons learned from the events of 1998 and were subsequently approved by the Board of Governors at the Annual Meeting in 1999.

As summarised in the Report of the 'Board of Directors to the Board of Governors on the Capital Resources Review', the main findings of CRR2 were that:

- 'Overall economic and risk prospects in the countries of operations are projected to support portfolio growth and sustained transition impact.
- The Bank confronts a broad and differentiated set of transition challenges and opportunities across its countries of operations over the medium term.
- Based on the transition potential of the region, the Bank's medium term operational programme projects an expansion of its activities in the early and intermediate transition countries and in Russia while maintaining a significant level of operational activity in the advanced transition countries.
- The Bank has adequate capital to implement its medium term operational objectives under the operational and financial analysis considered in this review in line with its manageable growth strategy.'

Reflecting the strong implementation of CRR2 objectives and a relatively benign operating environment during the period 2001 to 2005, CRR3 pursued the strategic orientation of 'moving south and east' set out in CRR2 and introduced specific initiatives to provide new strategic impulses. These included:

- following the introduction of a geographically targeted approach with the ETC Initiative in 2004, the Western Balkans Initiative was launched in 2006;
- the launch of the Sustainable Energy Initiative in 2006 in the context of CRR3 focused on energy efficiency and climate change across sectors and countries of operations; and
- the definition of a renewed business model which adapted its core banking activity to evolving transition challenges and business environments, developed the competence to address new challenges and ensured appropriate controls.

The implementation of CRR3 and the formulation of CRR4 are affected by the crisis as described in sections 2 and 4. In this context, the G20 stated at their meeting in London in April 2009 for support "[to] ensure that all MDBs have the appropriate capital". In focusing on delivering these resources, the G20 Declaration noted the need to: "(i) make full and exceptional use of MDB balance sheets, to create further capacity for lending to meet crisis needs; (ii) review the need for capital increases at …the EBRD; (iii) take actions …to leverage private capital more effectively,…; and (iv) to increase support for trade finance." Following upon this, the Board of Governors requested the Bank at the Annual Meeting in May 2009 to examine its capital requirements.

Accordingly, the CRR4 combines the features of previous CRRs. As described in section 3, the CRR4 proposes to sustain the strategic shift 'south and east' which was a central component of the CRR3. In common with CRR2, the CRR4 is being formulated at a time when the portfolio of the Bank has been negatively impacted by an external crisis with a rise of impairment and provisions. This means that CRR4 must support the return of the EBRD to a positive profit outlook and the build-up of further reserves to support incremental risk taking.

2. CRR3 STRATEGIC IMPLEMENTATION REVIEW

2.1 CRR3 strategic objectives

The operational priorities and the strategic approach to portfolio management set in 'Moving Transition Forward: Operational Priorities for the Medium Term' provided the strategic framework for the formulation of CRR3. Taking account of the challenges and opportunities ahead, the strategic objectives of the Bank during CRR3 were to:

- sustain the **transition** focus and medium term transition impact of the Bank's portfolio;
- **generate and implement projects** to support the further shift of the portfolio towards the early and intermediate transition countries and to Russia;
- develop the Bank's **competence in new activities, products and sectors** relevant to the implementation of its mandate within a changing transition and business environment including capital markets instruments and equity, local currency financing and public private partnership financing structures;
- based on its experience to date, expand the Bank's **energy efficiency** activities and more generally investments that reduce emission of greenhouse gases;
- maintain a high **quality portfolio** in terms of transition, operational and financial parameters throughout the project life cycle;
- expand the operational reach of the Bank into **individual regions** of the countries of operations; and
- **renew the business model** to implement effectively and efficiently the above strategic directions.

The Assessment of Transition Challenges identified remaining transition challenges across EBRD countries of operations. These transition challenges were expected to translate and guide demand for Bank financing subject to its operating principles of transition impact, sound banking and additionality in accordance with approved policies. In line with this approach and building on its operational record set during CRR2, the Bank aimed during CRR3 to continue to shift its portfolio towards the early and intermediate transition countries and Russia while addressing transition opportunities in the advanced transition countries. Variations in the pace and directions of reforms and of liquidity in financial markets were expected to continue to affect the scope for transition impact and additionality of the Bank.

CRR3 operational objectives at the planning exchange rate of €$1.15 were to:

- develop the **portfolio** with a base case objective of €21.9 billion by 2010;
- achieve an annual **business volume** within an operating range of €3.3 to €3.9 billion. The number of annual projects and particularly the number of projects in the portfolio were projected to rise significantly;
- support the base case growth of the **portfolio share** of the early and intermediate transition countries and Russia to around 87% by 2010; and

- maintain a **private sector** development activity and a significant level of **equity** focus.

2.2 CRR3 transition impact

This section describes the transition impact of the Bank during CRR3. Section 2.2.1 provides an assessment of the extent to which Bank projects achieved their transition objectives as assessed at the time of project approval (the flow target) and during project implementation (the stock target). This part of the analysis makes extensive use of the Transition Impact Monitoring System (TIMS). Section 2.2.2 reviews the overall impact of Bank operations in each sector at the country level, taking into account project implementation, policy dialogue and TC activities.

The Bank has continued to finance successfully a high proportion of projects with strong transition impact potential. Over the CRR3 period 86% of projects were rated "excellent" or "good", with 14% rated "satisfactory". For most of the period the vast majority of projects have been on track to deliver their potential at maturity. However, the financial crisis has exerted significant negative effects. During the past year, 12% of all monitored projects have seen risk or potential rating downgrades, and this has reduced expected transition impact outcomes.

2.2.1 Transition impact ratings

The achievement of transition impact through the financing of projects remains the fundamental objective of the EBRD. All EBRD financed projects must, as a rule, satisfy minimum standards in respect of transition impact potential and risk. To assess the transition impact of its projects, the Bank uses a rating system designed to capture the strength of the incremental transition impact contribution of each project – the transition impact potential – and the likelihood that such contribution will happen – the risks to transition impact.

Transition potential and risk are measured along the following two ordinal scales:

Transition impact potential scale

Unsatisfactory	Marginal	Satisfactory	Good	Excellent

Risk to transition impact scale

Excessive	High	Medium	Low

These qualitative transition impact ratings are used to assess the quality at entry of the flow of new projects and to monitor changes in the quality of the stock of projects in the portfolio during implementation. The Bank's strategic transition objectives are conveyed as a component of the Bank's scorecard. Quantitative and qualitative objectives are also established in business group scorecards in terms of sector and country portfolios.

Flow target. An annual transition impact target has been set to ensure the quality of new projects as they are approved. This target is defined as the percentage of new projects (annual flow) rated "good or better for transition impact potential". The target is reviewed as part of each year's budget. From 2005, the target was set at 75% (with a range of 70%

to 80%). From 2008, a floor level was set at 80% of projects being rated as having "good or better" transition impact potential.

Figure 2.1 shows the transition ratings on new projects approved during the period 2005 to 2008, broken down into the two components, potential and risk.

Figure 2.1: Transition potential and risk of new projects 2005-2009

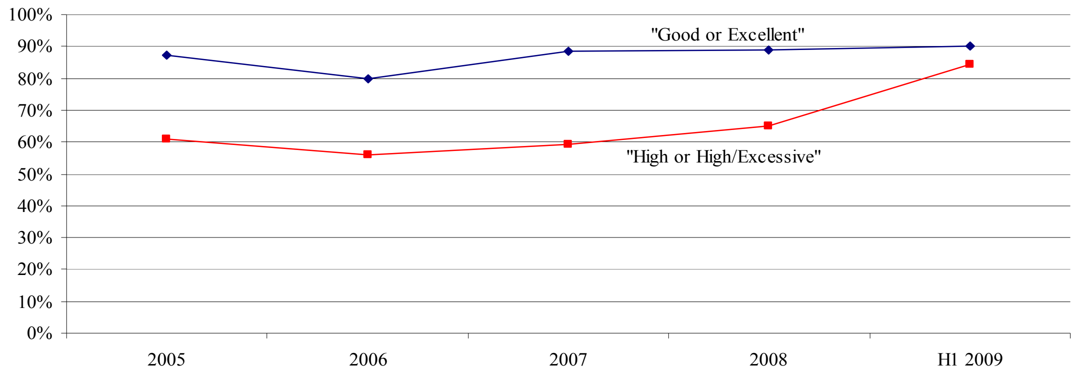


Figure 2.1 shows that the Bank has continued to implement successfully a high proportion of projects with strong transition impact potential. The diagram also shows that risk ratings for new projects have been rising since 2008. The proportion of new projects with "high or excessive" risks reached 65% in 2008 and rose quickly to reach 85% in the first half of 2009.

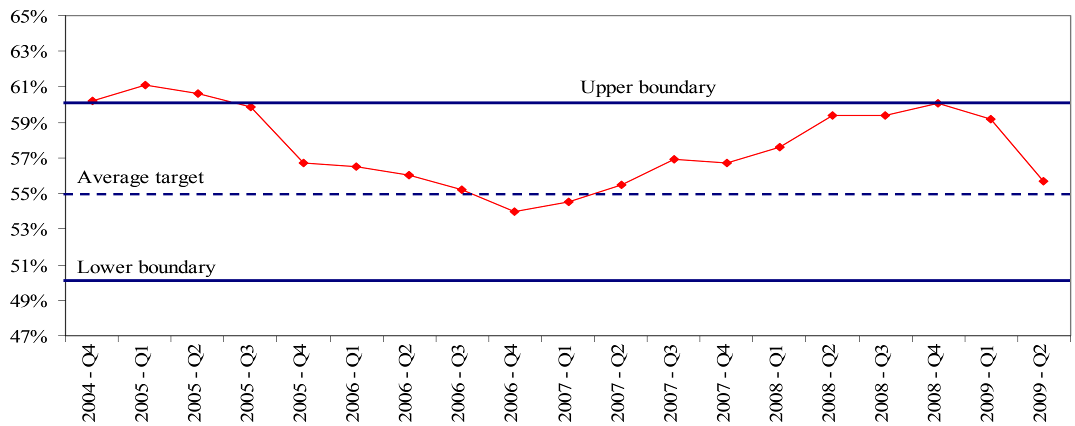
Stock target. The Transition Impact Monitoring System (TIMS), introduced in 2003, records the progress of Bank projects during implementation for both transition impact potential and risk. The transition rating on the Bank's portfolio of projects changes over time as new projects are added, old projects mature (completed, cancelled or pre-paid) and as the rating attached to existing projects alters (upgrades and downgrades) due to changed circumstances. The stock analysis of projects carried out through the TIMS database captures these changes and enables the Bank to continuously monitor the transition quality of its existing projects. In 2008, the stock target was set so that the proportion of projects in the TIMS portfolio with a rating of 4 or better (on a scale of 1-8) should fall within the range of 50 to 60 percent, with a base case target of 55%.

Table 2.1: Expected project transition impact rating

Ranking	Potential	Risk	Potential	Risk	Potential	Risk
1	Excellent	Negligible				
2	Excellent	Low	Good	Negligible		
3	Excellent	Medium	Good	Low	Satisfactory	Negligible
4	Excellent	High	Good	Medium	Satisfactory	Low
5	Good	High	Satisfactory	Medium		
6	Satisfactory	High	Marginal	Low/Negligible		
7	Marginal	Medium/High				
8	<any>	Excessive	Unsatisfactory	<any>		

For most of the period the vast majority of projects have been on track to deliver their potential at maturity. Figure 2.2 below shows that portfolio ratings have exceeded the minimum of this range over this period, and that on only two occasions (Q4 2006 and Q1 2007) did the portfolio rating slip below the mid-point of 55%.

Figure 2.2: Evolution of stock target, percentage of projects rated 1-4, 2005-2009



An analysis of the portfolio ratings was undertaken to assess the main sources of change over this period. From 2005 to 2006, the main factor behind the decline in the overall portfolio rating was that new projects being added to the portfolio were rated lower than the stock average, reflecting the higher risk ratings of incoming projects. By 2007, there was more balance between the ratings of the new projects entering the portfolio and the average of the portfolio itself. As the risk outlook began to improve, the overall ratings started to increase. This improvement in portfolio ratings continued through end-2008.

Since the end of 2008, however, the negative effects of the financial crisis on the transition performance of the Bank's project portfolio have become evident. During the past year, 12% of all monitored projects have seen risk or potential rating downgrades, and this has reduced expected transition impact outcomes. The percentage of projects in the portfolio with a rating of 4 or better dropped quickly during the first two quarters of this year, to currently just above the 55% mid-point.

2.2.2 CRR3 transition impact assessment

This section briefly reviews the Bank's transition impact during the CRR3 period at the sector level taking into account its investment projects (preparation and implementation), technical assistance and policy dialogue. The analysis is drawn from the Transition Impact Retrospective 2009.

Alignment with transition challenges. The transition challenges at the start of the CRR3 period were identified in the Assessment of Transition Challenges 2005. Using those assessments as a benchmark, the 2009 TIR concluded that the objectives pursued by Bank projects in the period 2005 to 2009 achieved some degree of alignment with these gaps, with certain challenges receiving more attention than others. In the Corporate and FI sectors, projects addressed mainly market structure (in 42% and 46% of projects

respectively) and market behaviour (45% and 48%) as transition objectives, bringing about valuable improvements in corporate governance, skills, and innovations. Less attention was paid to market supporting institutions (less than 10% in each sector), although the transition gaps there were significant. In the energy, energy efficiency and infrastructure sectors, transition objectives gave stronger priority to institutional and policy dialogue components (44% of operations).
The scope for EBRD influence on institutions and associated policy dialogue varies across sectors but, with hindsight, a better balance between ‘market expansion’ and ‘strengthening market frameworks’ might have helped build a greater resilience to potential shocks. The crisis has revealed the importance of market-supporting institutions in ensuring stability and this could be more of a focus in the Bank’s activities in the CRR4 period.

Sector level impacts. This section describes the results of the 2009 TIR analysis of the Bank’s transition impact at the sector level. This requires judgement as there is no simple mapping between project level impacts and impacts at the sectoral level. Given the Bank’s size, projects may cover only a small part of a sector, rendering the Bank’s ‘presence’ and ability to influence the reform process limited. In assessing the full impact of the Bank’s operations on transition in each sector a qualitative assessment of several additional factors is made, along with actual and likely project outcomes, to reach overall judgements.

To facilitate the comparability of results, the methodology underlying the assessment remains broadly consistent with that used in previous transition impact retrospectives. TIR 2009 distinguishes 13 sectors, similar to the previous TIRs. The analysis is based on the portfolio of Bank’s projects in a sector complemented by other possible channels of transition impact such as policy dialogue and TC. The achievements of transition impact are measured against the transition challenges defined for each sector in the Assessment of Transition Challenges in 2005. Based on collective judgements by various departments within the Bank (OCE, Banking (including Resident Offices) and EvD), transition impact in a particular sector is assessed on a scale from *no involvement*, *limited*, *moderate*, *significant*, to *very significant*.

On this basis, across 13 sectors in 29 countries of operation, 66% of all sectors were judged to have experienced ‘moderate’, ‘significant’ or ‘very significant’ impacts – a similar result to TIR 2005 – and confirms an important role for EBRD in advancing the transition process across countries of operations. ‘Significant’ and ‘very significant’ impacts made up 17% of the total. This is less than in TIR 2005 (30%) and to some degree may reflect a period of less intensive reform in the advanced transition countries (following EU accession) and in the energy producing countries like Russia and Kazakhstan (during a period of high oil prices). The global financial crisis has also played an important part in blunting the Bank’s impact at the sectoral level, as seen in downgrades to the transition impact potential of the stock of projects over the last twelve months.

The basic data underlying the assessment of impact at country and sector level is shown in table 2.2. The number and volume of Bank operations varied considerably over the period, ranging from countries such as Estonia and Latvia where few operations were carried out (as the additionality constraint became more binding) to Russia, Ukraine, Romania and Kazakhstan where significant volumes of investment were made. The table also shows the average transition impact potential of projects in each country over the review period, and the number and volume of TC assistance provided.

Table 2.2: Underlying data for the transition impact assessment

	Number of projects	EBRD investment volume (EUR mln)	Average transition impact project potential (TIMS)*	Number of TCs	TC volume (EUR mln)	Overall transition impact rating**
ALBANIA	17	216	1.2	37	6	1.5
ARMENIA	56	162	1.1	43	7	1.8
AZERBAIJAN	66	442	1.2	37	8	1.5
BELARUS	16	137	0.9	21	4	0.5
BOSNIA & HERZ.	31	612	1.0	50	7	1.5
BULGARIA	46	680	1.6	35	10	2.2
CROATIA	17	454	0.9	26	3	1.2
ESTONIA	1	1	0.3	1	0	0.5
FYR MAC.	14	153	0.6	40	5	0.8
GEORGIA	76	368	1.2	67	13	1.8
HUNGARY	13	170	0.5	2	0	0.8
KAZAKHSTAN	49	1,187	1.8	62	15	1.6
KYRGYZ REP.	31	40	0.6	63	12	0.7
LATVIA	1	20	0.0	2	0	0.4
LITHUANIA	8	57	0.1	3	0	0.5
MOLDOVA	30	141	1.2	28	6	1.5
MONGOLIA	20	134	0.9	56	9	1.0
MONTENEGRO	8	53	0.3	40	7	0.8
POLAND	26	552	1.0	4	0	1.6
ROMANIA	70	1,371	2.0	44	11	2.3
RUSSIA	233	4,961	2.0	178	43	2.2
SERBIA	51	685	1.4	212	23	1.8
SLOVAK REP.	7	75	0.1	4	2	0.8
SLOVENIA	5	37	0.2	3	0	0.2
TAJIKISTAN	29	58	0.5	59	14	1.2
TURKEY	0	0	0.0	1	0	0.0
TURKMENISTAN	2	1	0.2	11	1	0.0
UKRAINE	101	2,481	2.0	110	25	2.2
UZBEKISTAN	18	45	0.7	17	5	0.5

* Refers to transition potential as of H1 2009 and includes only projects rated. Where there are no projects in a sector, or when none have been rated, 0 rating has been applied.

** Simple average based on a scale of 0=No involvement to 4=Very significant

Most of the "significant" and "very significant" overall impacts were recorded in the infrastructure sector (almost half the total) whereas, in contrast to TIR 2005, none were registered in the banking sector. "Moderate" overall impacts were fairly evenly spread across the three main sectoral groups.

The Bank has also been successful in supporting sustainable energy, a new focus area of Bank's activities in the past few years. Using the Sustainable Energy Initiative (SEI) as a core tool for achieving impacts in the sector, the Bank finances the efficient use of energy that cuts demand and imports, reduces pollution and mitigates climate change through carbon emission reductions. Spanning across several sectors, the Bank has achieved an important impact in a number of countries such as Armenia (through the renewable energy programme), Bulgaria, Ukraine (industrial energy efficiency), and Russia (mainly industrial, power and MEI energy efficiency). In Bulgaria, the Bank supported the development of Renewable Energy Systems (RES), engaged in policy dialogue on RES support systems, and contributed to some regulatory reforms in the sector. Mini-hydro and large wind farms contributed significantly to improving the investment climate for renewable energy in the country. Furthermore, the Bank supported improvement in energy efficiency across the economy.

Impacts at the country level. At the regional level, the assessment suggests that Bank financed activities had strong overall transition impact in Russia, EEC and SEE. This supports the strategy of moving south and east. The impact of Bank operations was found to be highest in a small group of countries: Bulgaria, Romania, Russia and Ukraine. These countries accounted for 62% of total EBRD investment volume in the past five years, indicating that at the country level there has been a positive alignment between the allocation of investment and overall impact. At the other end of the spectrum, the countries where the Bank financed activities had lowest overall impact were those where operations had been reduced (Hungary, Estonia, Slovak Republic, Lithuania, Latvia and Slovenia) or where the business and policy environment was more constraining (Belarus, Kyrgyz Republic and Uzbekistan).

Crisis effects. The global financial crisis has had an adverse impact, particularly in the Financial Institutions sector (and, to a lesser extent, the Corporate sector) reflecting, among other things, significantly increased commercial risks, which have threatened the basic viability of many projects; considerably reduced prospects of privatisations and IPOs; cancellations of credit lines, affecting for example several MSME projects; and damage to new financing methods, including syndications, where market conditions have reversed prospects rather than supported them. An additional effect of the crisis has been the re-engagement in the CEB region. Since the end of 2008, some 23% of crisis response projects have been in Central Europe and the Baltics.

2.3 CRR3 operational performance

This section reviews the operational performance of the Bank relative to the strategic objectives and projections set out in the third Capital Resource Review (CRR3). This analysis includes an examination of the main drivers of the Bank's portfolio development for the period 2006 to 2009 together with the 2010 projections as set out in the 2010 Business Plan and Budget.

Reported amounts for the CRR3 period have been influenced by the impact of the significant variations of the euro/dollar exchange rate. During the CRR3 period, the euro/dollar exchange rate fluctuated within a wide range from €/$1.19 during 2006 to close to €/$1.60 in 2008. At the end of 2009, the euro/dollar exchange rate stood around the middle of this range at €/$1.44. In order to neutralise the impact of these large exchange rate variations on reported volumes of operations and assets stock, the analysis in this section includes both an assessment at reported rates and at the planning rate of €/$ 1.30, providing a basis for comparison of the Bank's performance over the five year CRR3 period.

2.3.1 Annual business volume

Table 2.3 shows actual **annual business volume** compared to the original CRR3 projections for the CRR3 period. Cumulative annual business volume during this period is projected at around €32.2 billion at the planning rate, around 70% above the original CRR3 projection. In addition to the impact of Mongolia and Turkey as new countries of operations, this differential reflects high transition business volume during the early part of CRR3 and the Bank's response to the economic and financial crisis from the end of 2008 resulting in a marked increase of the Bank's annual business volume in 2009 and 2010. Annual business volume increased year-on-year with the exception of 2008 where the impact of the crisis on the processing of the Bank's pipeline late in the year resulted in a volume decrease relative to the previous year.

Table 2.3: CRR3 annual business volume

€ billion	2006	2007	2008	2009	2010 BP
CRR3 (€/$ 1.15)	3.70	3.75	3.80	3.85	3.90
Actual	4.94	5.58	5.09	7.86	8.00
Actual (at planning rate)	4.96	5.85	5.27	8.17	8.00

Table 2.3 shows the composition of the Bank's annual business volume by transition stage. Actual annual business volume was higher than projected for the CRR3 period across all regions with cumulative business volume in the early and intermediate transition countries and Russia exceeding by around 60% the CRR3 projection and cumulative business volume in the advanced transition countries - more than double the CRR3 projection reflecting the impact of the Bank's crisis response in the latter part of the CRR3 period.

The **geographic composition** of cumulative CRR3 annual business volume was originally projected at 53% in the early and intermediate countries, 37% in Russia and 10% in the advanced transition countries. As at the end of 2008 and prior to the full impact of the Bank's response to the economic and financial crisis and the introduction of Turkey as a new country of operations, the composition of cumulative annual business volume closely matched the original CRR3 cumulative projection with the share of the early and intermediate transition countries at 52%, the share of Russia 1% above the projected share and the actual share of the advanced transition countries at the CRR3 projected share of 10%.

As a result of both the crisis response activity and the start of operations in Turkey, the geographic composition of the Bank's cumulative business volume for the whole of the CRR3 period is projected to differ from the original CRR3 projection with the share of the advanced transition countries around 4% above the projected CRR3 share at 14%, the share of Turkey at 2%, the share of Russia 2% below the originally projected share of 37% and the share of the early and intermediate transition countries 3% below the projected share.

Reflecting the Bank's CRR3 strategic portfolio development shift towards the early and intermediate transition countries and Russia, the combined share of cumulative business volume in the early and intermediate transition countries and Russia is projected to grow from 70% in the CRR2 period to 85% for the CRR3 period.

Table 2.4: CRR3 annual business volume by transition stage

CRR3 (€ billion at €/$ 1.15)	**2006**	**2007**	**2008**	**2009**	**2010**
Early and intermediate	2.0	2.0	2.1	2.1	2.1
Russia	1.2	1.3	1.4	1.5	1.6
Advanced	0.6	0.5	0.4	0.3	0.3

CRR3 (€/$ 1.15)	**2006**	**2007**	**2008**	**2009**	**2010**
Early and intermediate	54%	53%	54%	53%	53%
Russia	31%	35%	37%	39%	41%
Advanced	15%	12%	9%	8%	6%

Actual (€ billion at planning rate)	**2006**	**2007**	**2008**	**2009**	**2010 BP**
Early and intermediate	2.4	2.9	3.0	3.9	3.8
Russia	1.9	2.4	1.9	2.5	2.6
Advanced	0.7	0.5	0.3	1.6	1.3
Turkey	-	-	-	0.1	0.4

Actual (at planning rate)	**2006**	**2007**	**2008**	**2009**	**2010 BP**
Early and intermediate	48%	50%	58%	47%	48%
Russia	38%	41%	36%	31%	32%
Advanced	14%	9%	6%	20%	16%
Turkey	-	-	-	2%	5%

The **sector composition** of cumulative annual business volume for the CRR3 period was projected at 45% in the corporate sector, 31 % in the infrastructure sector and around 25% in the financial sector. Influenced by the Bank's response to the financial crisis and strong requirements in the financial sector during the period, the actual share of financial sector annual business volume for the CRR3 period is projected at around 39%. The corporate sector share of the cumulative CRR3 business volume is projected to be below the original CRR3 projection at 32% and the share of the energy and infrastructure sector is projected at around 29%, close to the original CRR3 projection. The lower relative share of the corporate sector is largely attributable to the sectoral structure of the initial crisis response which focused on the financial sector. While the Bank developed short term financing activity in the corporate sector to support short term financing requirements, the initial impact of the crisis has led to an overall decrease of corporate investment which drives the Bank's corporate finance activity.

The **product composition** of cumulative business volume for the CRR3 period is projected at around 68% for non-sovereign debt. Sovereign debt is projected to account for around 8% of the cumulative business volume for the period and equity is projected to account for around 20% share by the end of 2010 compared to 18% in the original CRR3 projection.

The **private sector** share of the cumulative annual business volume for the CRR3 period is projected to reach 84% at the end of 2010.

The projected cumulative **number of operations** for the CRR3 period was 1,414. The projected actual cumulative number of operations at the end of 2010 is estimated at 1,606, around 14% above the projected CRR3 level reflecting increased operational activity over the period.

An examination of the annual number of operations over the period shows that:

- the annual number of operations increased from 301 in 2006 to a projected 340 in 2010 remaining consistently above the CRR3 projections;
- 2007 was an exceptional year in terms of the number of operations terms driven by high activity levels under a number of framework facilities including the Russia Small Business Fund, the Armenia Multi-Bank Framework facility, the Local Enterprise Facility, various country specific MSME financing frameworks and energy efficiency credit line frameworks. In addition, the number of commitments under the ETC Initiative frameworks reached a record level of 45 and the Bank participated in 16 equity funds compared to 6 in 2008; and
- the variation of average project size during the CRR3 period had a direct impact on the annual number of operations. Average project size remained relatively constant at around €15 to €16 million during the period 2006 to 2008. Reflecting the nature of the Bank's crisis response activity, average project size increased to more than €24 million in 2009 and is projected at around €22 million in 2010.

Table 2.5: CRR3 annual number of operations

	2006	2007	2008	2009	2010 BP
CRR3	250	282	292	293	297
Actual	301	352	302	311	340

2.3.2 Disbursements

Cumulative **disbursements** for the CRR3 period were projected at €15.3 billion with actual cumulative disbursements at the end of 2010 currently estimated at €24.6 billion at a planning rate of €/$1.30, around 60% above the projected level at the time of the CRR3 preparation. An examination of annual disbursements for the period shows that:

- annual disbursements grew from €3.8 billion in 2006 to €5.7 billion in 2009 reflecting the increase in size of the Bank's portfolio;
- the geographic composition of disbursements shifted during the CRR3 period reflecting the composition of annual business volume during the period. The share of disbursements in the advanced transition countries decreased from 17% in 2006 to 10% in 2008. As a result of the crisis response activity during 20009 and 2010, disbursements in this region are projected to account for 17% in 2010. Disbursements in the early and intermediate transition countries are projected to account for over 52% of annual disbursements in 2010 compared to 43% in 2006; and
- the sector composition of cumulative disbursements for the CRR3 period is projected at around 34% in the corporate sector, 38% in the financial sector and 28% in the energy and infrastructure sector.

Table 2.6: CRR3 disbursements

€ billion	2006	2007	2008	2009	2010 BP
CRR3	2.7	3.1	3.1	3.2	3.2
Actual	3.8	4.1	5.0	5.5	5.8
Actual (at planning rate)	3.8	4.3	5.1	5.7	5.8

Table 2.7 examines the development of **undrawn commitments** during the CRR3 period. Reflecting the increase in annual business volume, the stock of undrawn commitments grew initially from €6.4 billion in 2006 to €7.0 billion in 2007 and stabilised in 2008 as a result of the higher disbursements. As a result, the undrawn ratio decreased from 36% in 2006 to 29% in 2008 and is projected to be around 28% at the end of 2010. This reflects strong demand for Bank financing and effective portfolio management with a significant increase in the portfolio accompanied by a marked increase in disbursements resulting in a stable ratio of undrawn commitments.

Table 2.7: Undrawn commitments over CRR3 period

	2006	2007	2008	2009	2010 BP
Actual (at planning rate)	6.4	7.0	6.3	8.1	9.0
Undrawn ratio	36%	35%	29%	29%	28%

2.3.3 Reflows

Table 2.8 provides the development of reflows during the CRR3 period including cancellations. Projected cumulative reflows at the time of the CRR3 preparation were estimated at €10.6 billion. Actual cumulative reflows revalued at the planning rate are projected to reach €14.9 billion at the end of the CRR3 period, 41% higher than originally projected. This trend reflects the higher operating assets level resulting from increased activity during the CRR3 period. While the ratio of reflows as a share of previous year end operating assets rose to 27% in 2006 as a result of strong prepayment and divestment levels, the crisis has led to a decrease of this ratio to 15% in 2009. As tight liquidity conditions are expected to continue in 2010, annual reflows are projected to remain at around 14% of the previous year end operating assets stock in 2010 at €3.1 billion, 35% above the original CRR3 projection. Reflows are an important operational parameter from a capital management perspective as they reflect the rate of portfolio turnover and decrease the pressure on capital utilisation.

Table 2.8: Reflow development during CRR3

	2006	2007	2008	2009	2010 BP
CRR3 (€/$ 1.15)	2.0	2.0	2.1	2.2	2.3
Actual	3.1	2.6	2.4	3.1	3.1
Actual (at planning rate)	3.1	2.8	2.5	3.2	3.1

Table 2.9 shows a breakdown of reflows during the CRR3 period. An examination of the main reflow trends shows that:

- while repayments remained fairly stable during the first three years of the CRR3 period at around €1.4 billion, repayments increased in 2009 by around 20% and are projected to reach €1.9 billion in 2010;
- the level of prepayment in 2006 reflected large prepayment activity in the energy sector which resulted in a decrease of energy sector reflows in subsequent years. As a result of the global financial crisis and liquidity shortage, prepayment levels were low in 2008 and 2009 and are projected to increase marginally in 2010. The cumulative level of prepayments during the CRR3 period remained broadly constant compared to the CRR2 period at around €2 billion;
- the level of equity divestments decreased sharply between the earlier and latter part of the CRR3 period. The ratio of divestment to previous year equity operating assets decreased from 21% in 2006 to 4% in 2009 reflecting difficult equity market conditions and a continuing rise in equity operating assets over the period; and
- write-offs remained low in the period 2006 to 2009 and are projected to rise to around €120 million in 2010 reflecting the growth of impaired assets resulting from the impact of the financial crisis on the Bank's portfolio.

Table 2.9: CRR3 reflows by type

€ billion	2006	2007	2008	2009	2010 BP
Repayments	1.5	1.3	1.4	1.7	1.9
Prepayments	0.6	0.4	0.2	0.4	0.3
Divestments	0.5	0.4	0.4	0.2	0.2
Write-Off (€ million)	49	9	16	50	120

Cancellations of unutilised commitments are projected at an average of €0.6 billion a year during the period 2006 to 2010, above the level of €0.4 billion in the original CRR3 projection and reflecting the actual growth of the Bank's portfolio.

2.3.4 Portfolio

The CRR3 analysis projected that the **portfolio** would reach €21.9 billion by the end of 2010, 24% up from the end 2006 portfolio. The actual portfolio revalued at the planning rate of €/$1.30 reached €27 billion by the end of 2009 and is projected to reach around €31 billion by the end of 2010, 41% above the level projected at the time of the CRR3 preparation. This reflects the combined effect of the increased annual business volume and the decrease in the reflow ratio during the period reflecting the impact of the economic and financial crisis.

Table 2.10: CRR3 portfolio development

€ billion	2006	2007	2008	2009	2010 BP
CRR3 (€/$ 1.15)	17.6	18.8	20.0	21.0	21.9
Actual	17.7	19.4	21.5	25.6	30.9
Actual (at planning rate)	17.7	20.2	22.1	26.5	30.9

Table 2.11 shows the development of the **number of portfolio operations** during the CRR3 period. In this table, the CRR3 objective has also been restated to take into account the rebooking of the Bank's managed fund equity portfolio from individual sub-investments to consolidated funds following the implementation of the Bank's equity processing system which had the effect of reducing the portfolio number of operations by approximately 110.

The number of operations in the Bank's portfolio grew continuously during the CRR3 period as a result of increased operational activity. The number of operations in the portfolio is projected to reach around 1,591 operations by the end of 2010, 24% above 2006 and 4% above the restated CRR3 projection. This trend reflects the larger than projected share of the Bank's annual business volume in the form of repeat business with existing clients (i.e. excluding follow-on tranches or capital increases, which resulted in a lower addition of new operations in the portfolio. Additionally, the number of project completions has been higher than initially projected reflecting high prepayment and divestment levels during the first half of the CRR3 period. The combination of the above two elements has constrained the impact of increased business activity on the growth of the portfolio number of operations.

Table 2.11: CRR3 number of portfolio operations

€ billion	2006	2007	2008	2009	2010 BP
CRR3	1,319	1,421	1,508	1,566	1,633
CRR3 restated	1,223	1,325	1,412	1,470	1,537
Actual	1,284	1,341	1,416	1,491	1,591

An examination of the **portfolio regional composition** in table 2.12 shows that:

- at the end of 2008, before the impact of the crisis on Bank activities and before the start of Bank operations in Turkey, the actual regional composition of the portfolio was closely aligned to the CRR3 projection with the share of the portfolio in the early and intermediate transition countries share at 52%, 1% above the CRR3 projection for 2008, the share of Russia at 31% share precisely in line with the projected share and the share of the advanced transition countries at 17%, 1% below the CRR3 projection; and

- the projected regional portfolio composition at the end of 2010 reflects the composition of the Bank's crisis response and the addition of Turkey as a country of operations. As a result, the share of the advanced transition countries is projected at 18% at end 2010 compared to 13% in the CRR3 projections. By the end of 2010, the share of Russia is projected at 30% compared to 35% in CRR3, the share of the early and intermediate transition countries at 51% (53% share in CRR3) and the share of Turkey at 2% of the Bank's portfolio.

Table 2.12: CRR3 portfolio geographic composition

CRR3	**2006**	**2007**	**2008**	**2009**	**2010**
Early and intermediate	49%	50%	51%	52%	53%
Russia	27%	29%	31%	33%	35%
Advanced	24%	21%	18%	15%	13%

Actual (at planning rate)	**2006**	**2007**	**2008**	**2009**	**2010 BP**
Early and intermediate	47%	49%	52%	51%	50%
Central Asia	*6%*	*8%*	*8%*	*8%*	*8%*
Eastern Europe and Caucasus	*15%*	*17%*	*19%*	*19%*	*19%*
South Eastern Europe	*26%*	*24%*	*24%*	*24%*	*23%*
Russia	28%	30%	31%	30%	30%
Advanced	25%	21%	17%	19%	18%
Turkey	0%	0%	0%	1%	2%

The **portfolio sector composition** by the end of the CRR3 period is projected to be around 36% in the infrastructure sector compared to 35% in the original CRR3 projection. The corporate and financial sectors are projected to account for around 32% of the Bank's portfolio compared to 40% and 25% respectively in the original CRR3 projection.

2.3.5 Operating assets

The Bank's operating assets are projected to more than double by the end of 2010 compared to 2006, 54% above the original CRR3 projection. This reflects the combination of strong disbursements during the period and the relative low level of operating assets reflows as described in section 2.3.3.

Table 2.13 compares the operating assets development over the CRR3 period with the original CRR3 projection. An examination of table 2.13 shows that:

- the level of operating assets is estimated to more than double over the full CRR3 period, compared with a growth of 38% originally projected in the CRR3; and

- the average annual net operating assets growth (NOAG) is projected at around €2.4 billion over the CRR3 period compared to close to €1 billion in the original CRR3 forecast. Whilst the original CRR3 projection assumed a declining level of NOAG, the actual results show a relative slow start in the early part of CRR3 reflecting strong reflow pressure in the period 2006 to 2007 followed by an average annual net operating assets growth in the region of €3 billion from 2008 onwards as the full impact of the increase of annual business volume occurred and the level of reflow due to the financial crisis dropped.

Table 2.13: CRR3 operating assets development

€ billion	**2006**	**2007**	**2008**	**2009**	**2010 BP**
CRR3 (€/$ 1.15)	10.4	11.6	12.6	13.6	14.3
Actual	10.9	12.3	15.1	17.9	21.9
Actual (at planning rate)	10.9	12.8	15.5	18.6	21.9

Table 2.14 show the **regional composition of operating assets** resulting from regional composition of disbursements and reflows during the CRR3 period. An examination of table 2.14 shows that:

- operating assets in the early and intermediate transition countries are projected to grow from 40% in 2006 to 48% share in 2010 reflecting the increased level of disbursement in the period. This compares with 52% at the end of 2010 in the original CRR3 projection;
- Russia is projected to remain broadly constant throughout the CRR3 period at around 33% of operating assets compared with 34% originally projected for the end of 2010; and
- the share of the Bank's operating assets in the advanced transition countries is projected at around 19% at the end of 2010 compared to 14% in the original CRR3 projection reflecting the Bank's crisis response activity in the region. Turkey is projected to account for less than 1% of the Bank's operating assets by the end of 2010.

Table 2.14: CRR3 operating assets geographic composition

Actual (at planning rate)	**2006**	**2007**	**2008**	**2009**	**2010 BP**
Early and intermediate	40%	42%	46%	47%	48%
Russia	31%	33%	34%	33%	32%
Advanced	30%	25%	20%	19%	19%
Turkey	-	-	-	1%	1%

2.3.6 Portfolio quality and performing assets

This section examines the portfolio quality trends over the CRR3 period in terms of portfolio risk and asset impairment. The overall portfolio risk measured by the weighted average facility risk for the period 2006 to 2009 is shown in table 2.15. Overall portfolio risk deteriorated sharply starting in 2008 as the global crisis unfolded with weighted average facility rating increasing from 5.48 at the end of 2006 to 6.11 at the end of 2009.

Table 2.15 shows that portfolio risk increased particularly in the advanced transition countries (16% increase between 2006 and 2009) reflecting the change in risk level from the pre-crisis position. Portfolio risk increased respectively by 8% and 12% in the early and intermediate transition countries and in Russia between 2006 and 2009.

Table 2.15: CRR3 portfolio weighted average facility risk by region
Planning rate €/$ 1.30

At planning rate	**2006**	**2007**	**2008**	**2009**
Early and intermediate	5.76	5.81	5.93	6.23
Russia	5.48	5.53	5.88	6.14
Advanced	4.95	5.02	5.51	5.76
Turkey	-	-	-	4.69
Overall	5.48	5.56	5.84	6.11

The deterioration in the risk profile of the portfolio as a result of the global crisis since 2008 translated in an increase in the level of assets impaired from €0.2 billion at the end of 2006 (2% share of operating assets) to €1.9 billion at the end of 2009 (10% share) of which €1.5 billion related to equity. At the end of 2009, 34% of equity operating assets were impaired compared to 2% of debt operating assets.

Table 2.16 shows the geographic distribution of the Bank's impaired asset stock for the period 2006 to 2009. At the end of 2009, the Bank's impaired assets in Russia accounted for more than half of total impaired assets at €1.0 billion (16% of the region's operating assets) of which 85% was equity. The impairment ratio in the early and intermediate transition and advanced transition countries reached 6% and 9% of the Bank's impaired assets respectively.

Table 2.16: CRR3 impaired assets trends by region

€ billion at planning rate	**2006**	**2007**	**2008**	**2009**
Early and intermediate	0.0	0.1	0.2	0.5
Russia	0.0	0.0	0.6	1.0
Advanced	0.1	0.1	0.2	0.3
Turkey	-	-	-	-
Total	**0.2**	**0.2**	**1.0**	**1.9**

2.4 CRR3 financial performance

The Bank's financial performance and growth in total statutory capital in the CRR3 period was predominantly driven by realised income from debt, equity and the return on the Bank's capital. This analysis of the Bank's performance covers the five year period to end 2010, with the results for 2010 based on the projections presented in the 2010 Business Plan and Budget document.

2.4.1 Total statutory capital

During the CRR3 period to end 2010, the Bank is projected to increase its total statutory capital base[1] by €4.3 billion to €26.9 billion. This is €1.6 billion higher than the €2.7 billion projected increase in the total statutory capital base to €25.3 billion by end 2010 under the original CRR3 projections. These results should be seen in the context of the varying economic environments experienced over the period, including the impact of the economic crisis in the latter part of the CRR3 period.

Table 2.17 illustrates the annual development in the total statutory capital base and the variance against the original CRR3 projections between 2005 and end 2010.

Table 2.17: Total capital resources compared 2005 - 2010

Total capital resources	2005 € million	2006 € million	2007 € million	2008 € million	2009 € million	2010 € million	Net growth 2005-2010 € million
Actual	22,622	24,248	25,091	25,389	26,317	26,902	4,280
CRR3 original projections	22,622	23,310	23,768	24,254	24,776	25,312	2,690

The primary components of the projected aggregate movement in total statutory capital during the CRR3 period are presented in table 2.18, compared to the original CRR3 projections.

Table 2.18: CRR3 Aggregate change in total statutory capital

€ billion	Aggregate Actual	Aggregate Original CRR3 projections
Realised income (before impairment)	4.9	3.2
Change in reserves and provisions for losses	(2.7)	(0.6)
Realised income after provision for losses	**2.2**	**2.6**
Change in reserves and provisions for losses	2.7	0.6
Write-offs	(0.3)	(0.2)
Other movements (including allocation to 'other purposes')	(0.3)	(0.3)
Total change in statutory capital	**4.3**	**2.7**

The change in total statutory capital represents the total change in unrestricted general reserves[2] together with adding back changes in reserves and provisions[3]. The statutory

1 Pursuant to Article 12.1 of the Agreement, the capital base is defined as unimpaired subscribed capital, reserves and surpluses. Pursuant to the Prudential Ratios Policy, the capital base is comprised of total subscribed capital, unrestricted general reserves, reserves and provisions for losses, write-offs and other reserve movements and is used in the determination of the Bank's gearing ratio.

2 The projected change in unrestricted general reserves and strategic reserve over the CRR3 period of €1.4 billion is equivalent to realised income after changes in reserves and provisions and other reserve movements; see section 2.4.6.

3 Reserves and provision for losses comprise loan loss reserve, special reserve, specific debt impairment and general portfolio provisions, and unrealised equity losses below cost.

capital base is reduced by write-offs, matched by a similar reduction in operating assets. The total €4.3 billion movement in the statutory capital base during the CRR3 period is comprised of €4.9 billion realised income before impairment and unrealised equity losses below cost, reduced by €0.3 billion of write-offs and €0.3 billion of other reserve movements[4]. The 2010 financial projections do not take into account of the 2009 Net Income Reallocation decision.

Realised income before movement in impairment and unrealised equity losses below cost in CRR3 is projected at €4.9 billion[5], or is €1.8 billion higher than originally projected. Realised income before impairment is reviewed in section 2.4.2.

Statutory capital includes cumulative impairment provisions for debt and equity losses below cost. Therefore movements in reserves and provisions for losses, whilst affecting the Bank's income, do not affect the Bank's statutory capital. The movements in reserves and provisions for losses are discussed in section 2.4.3.

2.4.2 Realised income before impairment6

Realised income before impairment during the CRR3 period was €5.0 billion compared to the original CRR3 projections of €3.2 billion. This variance is primarily driven by higher realised equity gains and the return on the Bank's capital in the period.

Table 2.19 presents the components, including the debt and equity return[7], of the aggregate realised income before impairment and write-offs during the CRR3 period compared to the original CRR3 projections.

Table 2.19: Aggregate realised income before impairment

€ million	Aggregate Actual	Aggregate Original CRR3 projections	Variance
Debt return	1,728	1,552	176
Equity return	2,415	1,251	1,164
Other income less administrative expenses	(1,178)	(1,009)	(169)
Allocation of the return on capital	1,885	1,415	470
Realised income (before impairment and write-offs)	**4,850**	**3,210**	**1,640**

The return from the Bank's equity portfolio was a major contributor to the Bank's realised profit before impairment and to the build-up of total statutory capital in the CRR3 period. The realised equity return was €1.2 billion higher than the original CRR3 projection and represented 66% of the total variance in realised income of €1.8 billion. In the first three years of the CRR3 period €2.3 billion of realised equity returns were achieved exceeding the original CRR3 projections by €1.3 billion. This was however

4 This primarily relates to unrealised losses on Treasury's available-for-sale portfolio.
5 Includes Treasury impairment which is treated as a realised loss.
6 Including the movements in accumulated equity losses below cost.
7 Debt return comprises banking net interest income and net fee and commission income and equity return includes realised equity gains and dividend income less equity cost of funds.

followed by a substantial reduction in the level of equity gains in the period 2009 and that projected for 2010.

The return on the Bank's capital in the CRR3 period was €0.5 billion or 33% higher than the original CRR3 projection. This was higher primarily due to the build-up of reserves and EURIBOR rates, particularly in the period 2007 through to 2009[8], being higher than the CRR3 assumption.

2.4.3 Total change in reserves and provisions for losses

The total movement in reserves and provisions for losses during the CRR3 period is projected at €2.7 billion compared to the original CRR3 projection of €0.6 billion.

Table 2.20 presents the projected total change in reserves and provision for losses in the CRR3 period, compared to the original CRR3 projections.

Table 2.20: CRR3 total change in reserves and provisions for losses

€ million	**Actual**	**Original CRR3 projections**
Loan loss reserve	636	101
Special reserve	110	12
Specific provisions	592	343
General loan portfolio provisions	284	47
Equity losses (incl. impairment)	1,062	56
Total movement in reserves and provisions for losses	**2,684**	**559**

The projected increase in specific and general debt provisions for impairment and loan loss reserve movements in the CRR3 period represented 56% of the total change in reserves and provision for losses of €2.7 billion. Increases in accumulated equity losses below cost (including impairment) represented 40% of the total change in reserves and provision for losses, with 4% representing allocations to the special reserve.

Over the CRR3 period a substantial increase of €1.5 billion in the total specific and general loan provisions and loan loss reserve movements is projected. Of this increase €0.6 billion relates to specific debt impairment. Over the same period loan assets are expected to more than double from €8.0 billion at end 2005 to a projected €16.2 billion by end 2010. In addition there has been a deterioration in the credit quality of the loan portfolio.

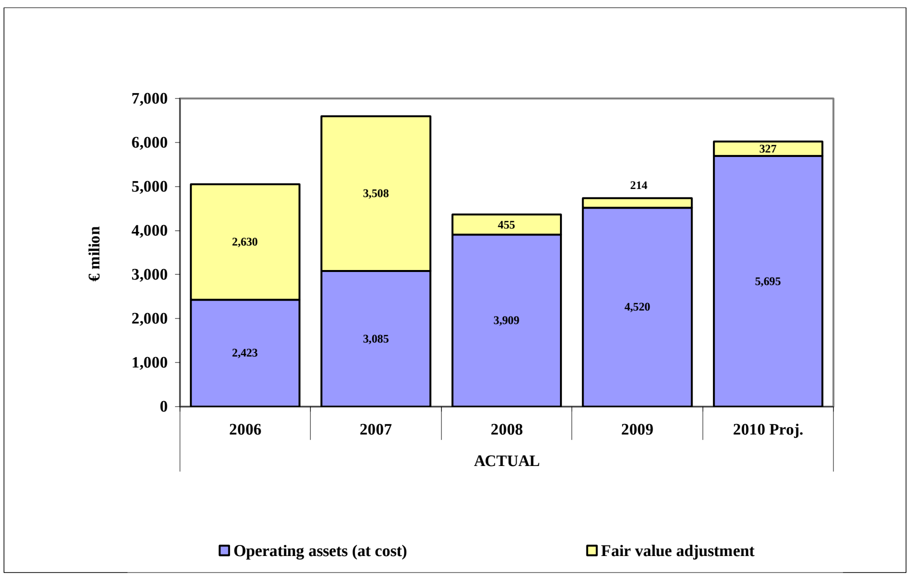
8 Return on capital achieved by the Bank in 2008 and 2009 reflects the impact of interest rate hedges undertaken.

An increase in accumulated equity losses below cost of €1.1 billion is projected over the CRR3 period, compared to an original CRR3 projection of €0.1 billion. Over the period total equity operating assets at cost are projected to grow from €2.2 billion at end 2005 to €5.7 billion at end 2010.

2.4.4 Net unrealised gains on the equity portfolio

The equity portfolio is held on the Bank's balance sheet at fair value. At the end of 2009, net unrealised equity gains (excluding equity derivatives) were €214 million, on €4.52 billion of investments at cost. Within this, valuations below cost represent €1.1 billion of losses and have been recognised through reductions in the Bank's net income over time. The Bank also had an estimated €1.3 billion of unrealised equity gains. The accumulated net unrealised gains on the Bank's equity portfolio at end 2010 are projected to be €0.3 billion, being €2.0 billion less than the original CRR3 projection of €2.3 billion. This follows a significant reduction in the Bank's unrealised equity gains as a result of the financial crisis. The Bank experienced a reduction in the accumulated net unrealised gains on equity from €3.5 billion at end 2007 to €214 million at end 2009.

Figure 2.3: Equity operating assets and cumulative net unrealised gains on equity 2006-2010



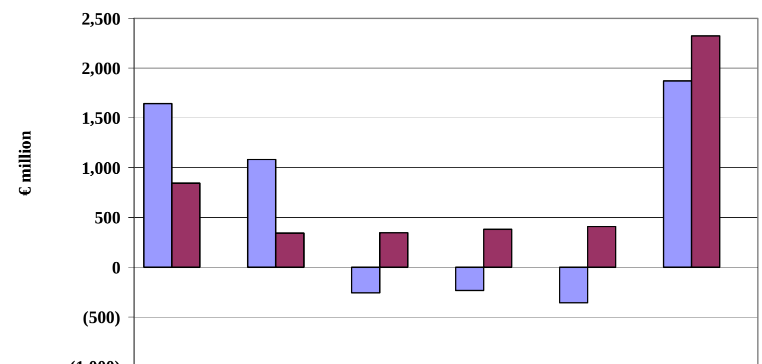
2.4.5 Net income

The Bank's net income or movement in unrestricted general reserves is determined by taking into account realised gains and losses, together with movements in unrealised losses below cost on equity and Treasury investments accounted for at fair value. Under this approach unrealised gains are excluded from the determination of net income. Figure 2.4 shows the Bank's net income and loss during the CRR3 period compared to the original CRR3 projections[9].

[9] Including projected 2010 results.

The actual aggregate net income of €1.9 billion is €0.4 billion less than the original CRR3 projections. This result mainly reflects the impact of actual impairment and accumulated losses on equity in the CRR3 period which was €2.0 billion higher than that assumed in the original CRR3 projections.

Figure: 2.4: Net income (loss) compared to original CRR3 projections



	2006	2007	2008	2009	2010	2006-2010
Actual net income/ (loss)	1,644	1,080	(259)	(233)	(360)	1,872
Net income original CRR3 projections	844	342	345	382	409	2,323
Variance	800	738	(604)	(615)	(769)	(451)

2.4.6 Summary

Despite the impact of the global financial crisis, the Bank is projected to have increased its statutory capital base by €4.3 billion during the CRR3 period, exceeding the original CRR3 projections. The equity portfolio, in terms of realised equity gains, was a key driver in the build-up of reserves during the CRR3 period, complemented by contributions from both the Bank's loan portfolio and the return on the Bank's free capital.

The aggregate of unrestricted general reserves and the strategic reserve are projected to increase from €1.7 billion at end 2005 to €3.3 billion by end 2010[10]. This compares to unrestricted general reserves at end 2010 of €3.7 billion in the original CRR3 projections.

The net movement in unrestricted reserves and strategic reserve, or aggregate net income over CRR3 is projected to be €1.6 billion. This is comprised of realised profit after impairment recognised in the income statement of €2.7 billion offset by an increase in unrealised losses below cost on the equity portfolio and Treasury assets of €0.1 billion,

[10] Prior to 2009 net income re-allocation decision.

other reserve adjustments of €0.7 billion in particular relating to the loan loss reserve and allocations to other purposes of €0.3 billion.

2.5 CRR3 resource utilisation

2.5.1 Overall framework

The medium term budget growth framework included in the third Capital Resource Review projected a staff ceiling increase within a range of 50 to145 positions and a real budget growth within a range of 9 to 18%, underpinned by a planned increase in the Bank’s productivity.

The Bank’s staff ceiling will increase by 145 positions within the CRR3 framework, being at the upper end of the CRR3 range, and equivalent to a 12.5% increase.

Cumulative real budget growth including the 2010 Budget is 16.1%, which is within the upper range of 18% for real budget growth for the five year period to 2010 set out in CRR3. This excludes a 3.8% increase relating to Crisis Response activities and a 1.9% increase relating to the depreciation of sterling.

Table 2.21: Headcount and expenditure growth during CRR3 period

	CRR3 Range			Increase
	Low		High	
Staff ceiling increase	50	-	145	145
Expenditure	9%	-	18%	16.1%

Annual business volume over the period will almost double from €4.3 billion to €8.0 billion, a volume growth of 86%, with the number of operations increasing by 23%. The Bank’s portfolio is also planned to grow by 84% with the number of operations increasing by 40% underpinned by increases in productivity.

Table 2.22: Annual business volume and portfolio growth during CRR3 period

	2005 Actual	2010 Plan	Increase
Annual business volume			
€ billion	4.3	8.0	86%
Number of operations	276	340	23%
Range		*320 - 370*	*16% - 34%*
Portfolio			
€ billion	16.8	30.9	84%
Number of operations	1134	1591	40%

2.5.2 Staffing

Headcount growth

Within the cumulative increase of 145 positions in the Bank's staff ceiling over the CRR3 period, 93 relate to resource growth excluding crisis response. This is almost equal to the CRR3 base case position growth assumption of 95. The Bank's crisis response accounts for an increase of 52 positions in the staff ceiling.

It was agreed at the time that the CRR3 framework was approved that additional headcount requirements for TC internalisation and the conversion of roles that had previously been undertaken by temporary agency staff or consultants would be treated as outside the CRR3 resource framework. These account for a further increase of 76 ceiling positions (49 TC internalisation and 27 conversions).
In total the Bank's staff ceiling will increase by 221 positions (or 19%) over the CRR3 period from 1,157 in 2005 to 1,378 planned for 2010. The increase of 145 positions is equivalent to a 12.5% increase.

Allocation of headcount. The Bank presents and monitors its budget according to a cost allocation structure. Table 2.23 shows the allocation of staff ceiling by cost allocation category over the CRR3 period. Headcount increases have been focused on direct project activity and project related departments with increases of 127 and 65 respectively.

Table 2.23: Staff ceiling by cost allocation category 2005 – 2010

	2005	2006	2007	2008	2009	2010
Direct Project Activity	654	692	736	736	771	781
Project Related Activity	234	255	278	280	297	299
Corporate Support	217	225	229	228	225	229
Institutional/Corp. Gov	55	59	64	66	66	66
Management Reserve	(3)	(1)	0	1	8	3
Total	**1,157**	**1,230**	**1,307**	**1,311**	**1,367**	**1,378**

Within direct project activity, the Banking Department will grow by 128 positions (or 21%) including a staff allocation of 26 crisis response related. Of this increase 35 positions relate to TC internalisation and 3 relate to conversions.

Between the 2005 and 2010 budgets, the share of Banking Department professional staff based in resident offices will increase from 45% to a projected 52%. Based on the 2010 Business Plan and Budget the number of Banking professional positions in the field will increase from 177 in 2005 to 277 in 2010 (an increase of 56%):

- In the CRR3 period new offices were opened in Ulaanbaatar (Mongolia), Podgorica (Montenegro), Samara, Rostov-on-Don and Krasnoyarsk (Russian Federation) and Istanbul (Turkey).

- The Russia region has experienced substantial resource growth during the CRR3 period due to the decentralisation of staff from headquarters to the Moscow office and the opening of three new offices in the region.
- The Bank's staffing in Ukraine will double in the CRR3 period from the 2005 level.
- As part of the consolidation of the Bank's resources in Central Europe, CRR3 anticipated the closure of some of the offices in the region. During the CRR3 period four offices in the Central Europe region have been closed including; Prague (Czech Republic), Tallinn (Estonia), Riga (Latvia) and Ljubljana (Slovenia).

By the end of 2010, it is planned that the Bank will have 34 resident offices. These offices, together with support from headquarters, will cover 29 countries of operations.

Headcount redeployment. To ensure efficiency and enhance staff productivity the Bank has placed strong emphasis in the implementation of CRR3 on the redeployment of existing positions to priority areas.
Reallocations in the Banking Department are supported by management analysis of productivity, the operational pipeline, skills issues including management and specialisation, and resource needs for strategic priorities. A total of 140 position reallocations within the Banking Department were implemented in the 2006 to 2010 budgets being a major driver of sustained resource productivity. Examples of reallocations in the CRR3 period include:

- The staffing in Central Europe resident offices will reduce from 38 professional and 29 support staff in 9 offices in 2005 to 27 professional and 14 support staff in 5 offices in 2010.
- The staffing of the Telecommunications and Property teams will reduce by 27% or 12 positions over the CRR3 period.
- For the professional staff based in resident offices, the proportion of sector team staff will increase from 24% in 2005 to 37% in 2010.
- There has been a decentralisation of the Russia country team. In 2005 there were 4 professionals in the country team based at headquarters and 16 based in Moscow. In 2010 there is one remaining professional staff member in HQ, supported by secondees from the field on rotation, and 25 professionals in the corporate team based in Moscow.

Further resources were redeployed in other areas of the Bank to enhance productivity. This has included:

- Restructuring of teams to enhance their project support including OCE and Environment.
- Reallocation of staff within Human Resources and Administration to better support the Bank's resident offices.
- Specific reviews of functions including IT.

2.5.3 Productivity

Productivity can be reviewed both in terms of operational volumes per staff member and in terms of number of operations per staff member. Whilst the focus of the Bank's analysis of productivity is on the number of operations, the increase in the planned average size of projects in CRR3 has contributed to the significant increase in annual business volume.

The composition of projects has changed and due to the crisis related activity there has been a particular increase in larger operations in the last two years of CRR3. Operations above €50 million in 2010 for example are projected to account for 11% of the total operations compared to 6% in 2005.

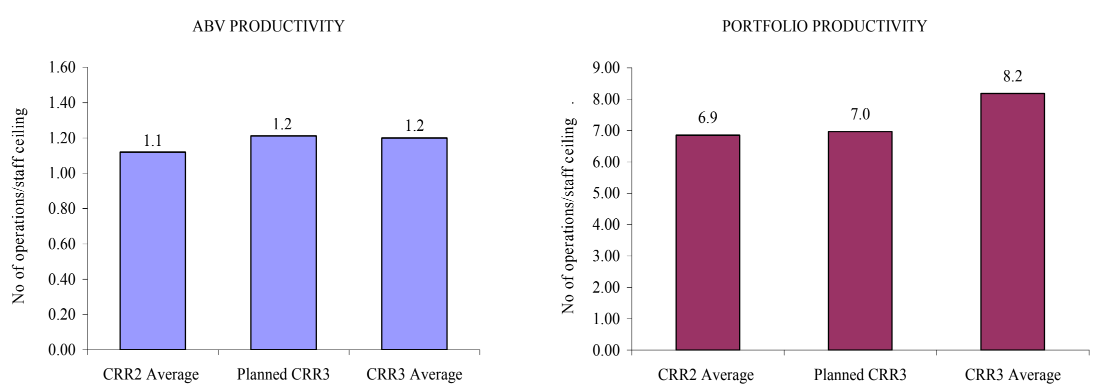
This has significant budget productivity implications as the average cost per million euro of a very small transaction (less than €5 million) is estimated at around 11 times higher than that of a large transaction (greater than €50 million) and around four times higher than that of a medium sized transaction (€10-50 million).

Annual business volume and portfolio productivity

Pipeline and portfolio productivity for both standalone and framework facilities are based on the average number of operations per Banking professional. Staff numbers have been adjusted based on the estimated share of time booked to pipeline development activities (60%) and monitoring activities (40%).

Productivity was projected to increase over the CRR3 period but at a lower rate than previously experienced given the challenges in the operating environment. As can be seen in Figure 2.5 projected average productivity over the CRR3 period for new signed operations is equal to the planned CRR3 productivity level, with portfolio monitoring productivity being higher.

Figure 2.5: CRR3 ABV and portfolio productivity



ABV productivity varies by year reflecting the variation in number of operations, with an average productivity in the CRR3 period of 1.2 projects per Banking professional, up by 9% from the average of 1.1 projects per Banking professional during the CRR2 period.

Portfolio productivity was on average 6.9 projects per Banking professional during the CRR2 period. For the CRR3 period 7.0 projects per Banking professional were planned. The projected average CRR3 portfolio productivity of 8.2 projects per Banking professional is higher than planned and 19% higher than during the CRR2 epriod, mainly driven by the rising number of projects in relation to the available resources in the later years of the period.

Overall productivity

Based on the adjusted staff ceiling for pipeline activities (60%) and portfolio activities (40%), productivity has increased overall by around 13% in CRR3 compared to CRR2.

2.5.4 Expenditure

The total operating costs budget has grown by £62 million or 44% over the CRR3 period. This includes £8.8 million relating to TC internalisation, headquarters occupancy adjustment and the IAS 18 adjustment, which are outside the CRR3 framework.

Budget utilisation of the sterling operating budget across the CRR3 period has varied between 97% in 2006 and 100% in 2008.

The Bank's euro operating budget has grown by €32 million or 15% over the CRR3 period from €212 million in 2005 to €244 million planned for 2010. The growth in euro expenditure is lower than that of sterling expenditure growth due to the €/£ budget rate reducing during the CRR3 period. The euro became stronger against sterling with a budgeted exchange rate of €/£1.50 for 2005-2008, €/£1.30 in 2009 and €/£1.20 for 2010.

Euro budget utilisation has varied between 84% in 2008 and 95% in 2007. This reflects the variance between budgeted and actual exchange rates used. 2008 was an exceptional year as sterling depreciated reaching an actual rate of €/£1.27 against a budgeted rate of €/£1.50.

Table 2.24: Operating budget growth

(million)		2005	2006	2007	2008	2009	2010
Sterling (£)							
	Budget	141	156	172	179	197	203
	Actual	133	150	167	179	193	
	Utilisation	94%	97%	97%	100%	98%	
EURO(€)							
	Budget	212	233	258	269	256	244
	Actual	188	219	244	227	231	
	Utilisation	89%	94%	95%	84%	90%	
Budget Rate €/£		1.50	1.50	1.50	1.50	1.30	1.20
Actual Rate €/£		1.41	1.46	1.46	1.27	1.20	

2.6 CRR3 statutory capital utilisation

Article 12.1 of the Agreement states that:

> "The total amount of outstanding loans, equity investments and guarantees made by the Bank on its ordinary operations shall not be increased at any time, if by such increase the total amount of its unimpaired subscribed capital, reserves and surpluses included in its ordinary capital resources would be exceeded".

The 'gearing ratio' set out in Article 12.1 of the Agreement Establishing the Bank has been defined to ensure that the Bank maintains a conservative utilisation of its capital considering the risk inherent in its portfolio.

The Bank reviewed the interpretation of the gearing ratio in 2008 and the Board approved a shift to an interpretation based on an adjusted portfolio. Reflecting the share of commitments which are unlikely to ever be disbursed, the adjusted portfolio basis provided a gearing ratio calculation assuming a level of 70% of undrawn commitments.

The interpretation of the gearing ratio was further examined in 2009 to ensure efficient capital utilisation within an appropriate prudential framework. This was particularly relevant and timely to allow the Bank to respond to the impact of the crisis in the region of operations in accordance with shareholder expectations while maintaining sufficient capital adequacy to safeguard the Bank's 'triple-A' rating. This analysis resulted in a shift of the gearing ratio from an adjusted portfolio base to an operating asset base.

Table 2.25 provides the reported capital utilisation excluding the strategic reserve for the period 2006 to 2009 and projection for 2010, together with the projected CRR3 capital utilisation. Actual figures reflect the interpretation of statutory capital utilisation in use at the time. Accordingly the gearing ratio prior to 2008 is computed as the ratio of the portfolio divided by subscribed capital and unrestricted general reserves. The 2008 result reflects the revised interpretation to an adjusted portfolio base and the inclusion of available reserves. From 2009, capital utilisation reflects an interpretation on an operating assets base. On this basis, table 2.29 shows that:

- CRR3 capital utilisation was projected to grow from 79% in 2006 to 92% by the end of 2010;
- actual reported capital utilisation increased from 76% at the end of 2006 to 84% at the end of 2007 reflecting increased annual business activity in that year, compared to a projected 82% capital utilisation in CRR3;
- reflecting the revisions in the interpretation of the gearing ratio, actual reported capital utilisation decreased to 80% in 2008 and to 70% in 2009. Accordingly, and in spite of significantly higher business volume than projected in CRR3, actual capital utilisation was 6% below projected CRR3 capital utilisation in 2008 and 15% below for 2009; and
- on the basis of the parameters of the 2010 Business Plan, capital utilisation at the end of 2010 is projected at 84% compared to 92% in the CRR3.

Table 2.25: Reported capital utilisation 2006-2010

	2006	**2007**	**2008**	**2009**	**2010**
CRR3 €/$ 1.15	79%	82%	86%	89%	92%
Actual	76%	84%	80%	70%	84%

3. CRR4 STRATEGIC FRAMEWORK AND OBJECTIVES

3.1 Mandate and operating principles

The Bank was established in 1991 to foster the transition towards **open market-oriented economies** and to promote **private and entrepreneurial initiative** in the central and eastern European countries[11].

Article 1 of the Agreement requires that the countries in which the Bank operates be committed to and apply the principles of **multiparty democracy, pluralism and market economics**. The monitoring of each country's commitment to these principles is performed in close cooperation with the European Union, the Organisation for Security and Cooperation in Europe, the Council of Europe and Ministries of Foreign Affairs of member states. Under the direction of the Board of Directors, the Bank has raised, in certain instances, compliance with some of these principles in a discreet yet effective manner.

The Bank is committed 'to promote in the full range of its activities **environmentally sound and sustainable development'** in accordance with Article 2 of the Agreement. All investment projects are screened in compliance with the Bank's environmental and social policy.

The Bank's mandate does not extend to direct lending for purely social purposes, such as education. The Bank's approach to projects in the social sector is selective, focusing on transactions in which the Bank's broader experience in infrastructure services and municipal finances can be applied consistent with the Agreement Establishing the Bank.

In carrying out its mandate, the Bank is guided by three key operating principles in selecting and approving projects: **transition impact, sound banking and additionality**.

At the time of the signing of the Agreement in 1990, eight countries of operations were signatories to the Agreement: Bulgaria, the Czech and Slovak Republic, the German Democratic Republic, Hungary, Poland, Romania, the Soviet Union and Yugoslavia. When the Bank started operations in April 1991, seven countries – the initial ones except the German Democratic Republic – became recipient countries as defined in the Agreement. Since then the number of countries in which the Bank operates has grown substantially. Following the admission of Albania, the dissolution of the Soviet Union and Yugoslavia, and the split of the Czech and Slovak Republics, the number of countries of operations of the Bank increased significantly. Following the graduation of the Czech Republic as a country of operations, the completion of the amendment process for Mongolia becoming a country of operations and the approval by the Board of Governors for Turkey to become a country of operations of the EBRD in 2008, there are currently 29 countries of operations. The analysis in this document is made on the basis of a constant

[11] The Agreement Establishing the Bank was amended in 2006 to add Mongolia as a country of operations.

region of operations during the CRR4 period with the exception of any country/ies requesting to graduate during this period.

3.2 EBRD comparative advantages

The EBRD has established over the years a unique range of specific experience and instruments to address the transition challenges of its region of operations and to fulfil the objectives set out in its medium term strategies. This provides the basis of its comparative advantages which underpin its effectiveness and distinguish it from other institutions and instruments of public policy. These advantages also enable shareholders to achieve certain goals more effectively and with lower public funding requirements than with other possible tools (such as budgetary policy and financial incentives) or compared with the possibilities offered by the private sector and other IFIs. Some of these advantages derive from the Bank's charter whereas others have been established over time. These comparative advantages, which were identified and endorsed as part of the strategic review process[12], underpin the effectiveness of the EBRD business model and are summarised below in terms of mandate, institutional and operational features.

Mandate features

- The **EBRD transition mandate** is a very special feature which ensures that the capital contribution of shareholders leads to actual systemic changes and progress in the region. This implies that client relationships go beyond financial transactions, encompassing non-financial support in fields such as environmental compliance, corporate governance, efficient public service delivery, procurement policies and integrity procedures.
- **Additionality** is scrupulously implemented by the EBRD's Board of Directors and management. This is important to shareholders as it ensures optimal leverage of public funds.

Institutional features

- The **global institutional shareholding** of the EBRD gives it broad support as well as neutrality and independence.
- The EBRD has a single **regional focus** specialising in one set of countries where it has accumulated a range of strong sector experience. This focused remit has been reinforced through local presence on the ground. No other institution has developed this combination of country/sector expertise in the region.

Operational features

- The EBRD has a **project focus** with a strong transactional culture. It has a concrete, tangible activity leading to a visible 'real economy' impact. It is engaged in the micro, rather than macro economic area and does not carry out policy or programme lending.
- The EBRD is a hybrid institution combining a **private sector focus** with a **public mandate and governance structure**. This allows the EBRD to be strategic in its purpose, pursuing public shareholder priorities, while having a dynamic business driven approach combined with discipline and governance.

[12] See "Fighting the Crisis, Promoting Recovery and Deepening Transition"

- The EBRD has a proven **risk-taking capacity** to take debt and equity risks, relying on the economic fundamentals of the projects it finances rather than on third party guarantees (such as sovereign guarantees or bank guarantees). Risk taking is based on strong credit structuring skills and experience built over time, as a result of its private sector exposure. The strength of the Bank's balance sheet is another factor that allows it to take calculated risks.
- The EBRD adheres to **high quality standards** both in terms of transition and credit, transparency, corporate governance, integrity, environment and procurement (evidenced in the high ranking given to EBRD in the 2008 Global Accountability Report published by the One World Trust).
- The EBRD has developed over time an effective **public-private mediation capacity** between the public sector and the private sector, because it has credibility with public authorities and has many aspects of a private sector management culture, and also the instruments to act with both the public and the private sector.

The strategic management task during the CRR4 period is to combine these comparative advantages in ways that effectively address crisis response, economic recovery and the broader transition agenda:

- given its relatively small size the EBRD should deploy its comparative advantages in a targeted manner, structured around the application and further sharpening of its core competencies;
- the transaction based approach of the EBRD remains a key defining feature and the driver of its transition and operational impact;
- the core competencies of the EBRD define its value to shareholders as a tool in the pursuit of specific public policy objectives; and
- efforts to strengthen the quality of state and markets will require the further build-up of the Bank's technical assistance and policy dialogue capabilities, including on a stand-alone basis.

3.3 Medium term operational priorities

The Bank began operations in April 1991 with an initial set of operational guidelines being approved shortly thereafter[13]. At the time of setting these initial operational priorities, the Bank recognised that these priorities would be reviewed based on experience.

A strategic review of the initial operational strategy was undertaken in late 1993 involving a Task Force on Operational Priorities. Based on the report of the Task Force, new operational priorities were established in early 1994 which underpinned the formulation of the first Capital Resources Review and the rationale for a capital increase. The key strategic themes contained in "**Operational Priorities: Guidelines for the Medium Term**" were:

- a focus on private sector development;

[13] "Operational Challenges: The Initial Action Programme"

- the need to be active in all countries of operations;
- the need to reach local private enterprises;
- the importance of financial intermediaries; and
- a more active approach towards equity investment.

In light of the changes in the region and of the impact of the 1998 financial crisis, Management and the Board of Directors undertook a strategic review in early 1999 which lead to the endorsement of "**Moving Transition Forward: Operational Priorities for the Medium Term"** by the Governors at the Annual Meeting in April 1999.

The priorities defined in "Moving Transition Forward" provided the strategic framework for the formulation of CRR3. The strategic review confirmed that the Bank's core business is the financing of projects, primarily in the private sector, which advance the transition, comply with sound banking principles and remain additional to alternative market sources of finance. Furthermore, the Bank requires sound business practices in all of its business partners and integrates an active approach to the environment into its work. Finally, the review introduced the strategic approach to portfolio management which underpins the development of the Bank's activity balancing transition, operational and financial parameters (see section 3.6).

In accordance with its mandate, the Bank fosters transition in all its countries of operations taking careful account of a country's commitment to economic and political reform, and responding in a positive and timely manner to advances in the transition. Specific priorities include the creation of sound financial sectors, the development of small and medium sized enterprises, the pursuit of commercial approaches for infrastructure development, a selective approach to the restructuring of viable large enterprises, a continued build up of equity investments and the promotion of a sound investment climate and stronger institutions.

The CRR3 provides a clear set of strategic objectives which the Bank has been implementing since 2006. However, close to 19 years after the inauguration of the EBRD, the region of operations, the understanding of the transition process and of the role of the Bank in this process have evolved. Furthermore, the global financial crisis has had a sharp impact in the region bringing a broad range of lessons on the transition, and raising a number of questions on priorities and of the meaning of transition itself. The Bank has also changed, developing over the years a range of competencies which have provided value to its shareholders and countries of operations. As the transition priorities evolve, it is important to ensure that the Bank remains equipped to address these priorities and shareholder expectations.

The drastic deterioration in the global and regional economic context during late 2008 and 2009, unforeseen at the time of the formulation of CRR3, required a close and strategic look at the Bank's capital and operations and at the role it could play in supporting transition under these circumstances. For this purpose, a strategic review process was launched in November 2008 to:

- enhance the timely integration of the short term response to the global financial crisis with the formulation of the medium term strategic direction of the Bank;

- define the evolving challenges of transition;
- provide a clearer strategic basis in terms of geographical and sector emphasis guiding the formulation of operational priorities and activities; and
- address in a timely and structured manner these topics as a basis for the technical preparation of the CRR4.

The strategic review process resulted in the formulation of the medium term strategy document titled 'Fighting the Crisis, Promoting Recovery and Deepening Transition'. This document sets out the short and medium term transition agenda, identifies the comparative advantage and core competencies of the EBRD and outlines opportunities for strengthened IFI cooperation. Its recommendations were considered and approved by the Board of Directors on 7 April 2009 and unanimously endorsed by the Board of Governors at the Annual Meeting in May 2009 providing the medium term strategic foundation for the formulation of CRR4.

Reflecting the evolution of the region and the impact of the crisis, medium term priorities include:

- a focus on transition and the deepening of democracy with a growing emphasis on qualitative dimensions of the transition such as institutional and environmental sustainability;
- support for financial sector stability and the resumption of normal conditions of financing for the real sector;
- the development of diversified and knowledge based economies that provide a basis for balanced and sustained economic growth and employment;
- the shift towards an energy efficient low carbon economy supporting energy security and economic competitiveness; and
- the acceleration of infrastructure, including environmental, investment based on a mix of ownership, management and financing models to enhance the long-term growth potential.

The **investment climate** impacts the Bank's ability to implement its mandate as the Transition Impact Retrospectives show that the Bank has been most effective where the environment has been supportive to transition impact. Building on its project activities and investor perspective, the Bank must continue to seek to promote a sound investment climate and to strengthen institutions that are important for the functioning of markets. A sound investment climate is based on a supportive and effective legal and regulatory framework, integrity and sound corporate governance, transparency and accountability of public administration, a firm stance against corrupt practices, fair and predictable taxation, and transparent accounting. The Bank will pursue clearly defined and achievable progress in these areas through project design, monitoring and through its work on legal transition. The use of country strategies in policy dialogue must also be pursued.

The effectiveness of the Bank also depends on the scope and quality of its work with other international institutions and donors. A co-ordinated approach is particularly important in view of the impact that policies, institutions and other aspects of the investment climate have on the Bank's ability to develop a sound pipeline of projects. The added policy leverage that comes with co-ordination can be decisive in ensuring that EBRD project conditionality is implemented. The Bank will thus continue to combine its particular strengths and abilities with those of other International Financial Institutions and of the European Union to achieve common objectives. The EBRD's special strengths include its project work with the private sector, its promotion of commercial approaches in the public sector, its relationships with enterprises and its investor perspective and skills. These skills and perspectives should inform and complement those of the EU and other IFIs in designing appropriate approaches and programmes.

3.4 CRR4 context

3.4.1 Economic context

Between the fourth quarter of 2008 and the second quarter of 2009, the EBRD region underwent the steepest economic contraction since the early years of transition. As of January 2010, the EBRD estimates that real GDP declined by just over 6% in 2009, albeit with significant differences across countries, ranging from double digit output contractions in the Baltic countries, Ukraine and Armenia to no contraction in Poland and Albania, Azerbaijan, and much of Central Asia. The contractions in late 2008 and the first half of 2009 were driven by severe and simultaneous shocks to exports, commodity prices and capital flows to the region. These shocks were aggravated by well-known vulnerabilities in many countries in the region, including high private external debt, excessive reliance of credit growth on external funding, and in some cases, denomination of household and corporate debt in foreign currency.

Output declines seem to have bottomed out in most countries, with many experiencing positive growth since the third quarter of 2009. In combination with the recovery of international financial markets and regional banking groups, as well as signs of a rebound in the advanced countries, a gradual recovery seems to be underway. However, these gains are as yet fragile and vulnerable to external and domestic shocks.

A global and euro area rebound is not yet assured. Recent data for advanced countries have disappointed expectations. Parts of the region are also exposed to additional risks arising from bond market concerns about fiscal sustainability in Greece and, possibly, other countries in the euro area. Fiscal policy in the euro area will provide less demand stimulus than in 2009, and will be tightened significantly in some countries, and monetary policy is widely expected to tighten in the second half of 2010. Faltering growth in advanced countries would also dampen oil price growth and growth in commodity exporters.

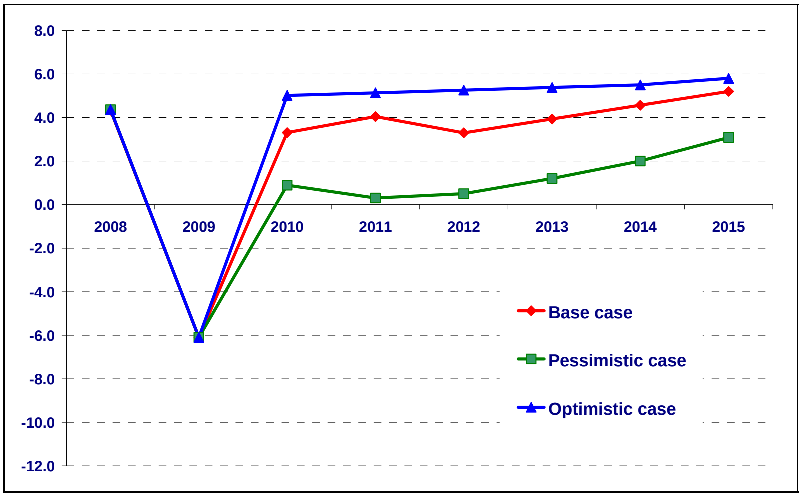
Domestically, non-performing loans and unemployment are expected to continue to rise through 2010 or 2011. As a result, banking systems may remain under pressure for some time and subsidiaries may continue to rely on support from parent banks. Credit growth is resuming only slowly and initially only in a few countries. The situation will remain particularly difficult in countries where excessive credit booms, often associated with asset price bubbles, have yet to fully unwind. Although risks of contagion are receding as the recovery takes hold, confidence in some banking systems is still vulnerable to spillovers from renewed turmoil in other countries in the region, for instance in the event of a forced adjustment of a pegged currency.

There are likely to be large cross-country differences in the pace of recovery. Countries with large export sectors, competitive exchange rates, and sound pre-crisis banking systems are best positioned to benefit from a recovery in the eurozone. By contrast, in countries with high nonperforming loans and weaker institutional frameworks for debt restructuring, the recovery is likely to remain constrained by slow credit growth resulting from continuing weakness in bank balance sheets. Even if commodity prices continue to rise, tight credit markets and restructuring needs in the manufacturing sector are expected to weigh on growth in Russia for several years. Consequently, economies that depend heavily on trade with Russia or remittances from migrant workers will also be negatively affected. Even countries with comparatively strong institutions, like the Baltic countries, are likely to experience protracted slow recoveries as deleveraging in the household, corporate, and banking sectors unfolds and economies adjust to a more sustainable, less domestic demand-driven, growth model.

Over the medium term, growth in the post-crisis period will depend on the global recovery, the unwinding of anti-crisis measures of the past year both domestically and globally, and the effect of the crisis on the general reform climate. Official intervention has created new vested interests, with state entities now playing a larger role in most countries. These interests may seek to secure protection against imports or otherwise limit competition. Some constituencies may also blame the sharp output decline on the growth model in the period leading up to the crisis, thus weakening reformers. To date, protectionist measures have been relatively moderate, and outright reform reversals have remained rare.

An important uncertainty for the medium term growth and reform scenario in the EBRD region lies in the external environment, including financial market conditions, and the economic disruption caused by balance sheet repair. Assuming no major reversals in reform policies, figure 3.1 summarises the EBRD's current medium term scenario for growth in the region, and charts possible downside and upside output paths. The pessimistic outcome could result if slow balance sheet repair constrained bank credit, feeding into slower firm growth and associated employment losses which, in turn, would weaken consumption growth. Combined with a weak external environment and political uncertainties, this could further strain credit quality and weaken bank balance sheets, in some countries possibly even triggering a loss of confidence in the banking system and/or the currency. On the upside, however, the global economy could rebound and external financing conditions could ease faster and more strongly than currently expected.

Figure 3.1: Average growth in the EBRD region (per cent)



EBRD projections as of January 2010; Preliminary 2009 estimates for the region point to a contraction of about 6.1%.

3.4.2 Medium term outlook for capital flows to the transition region

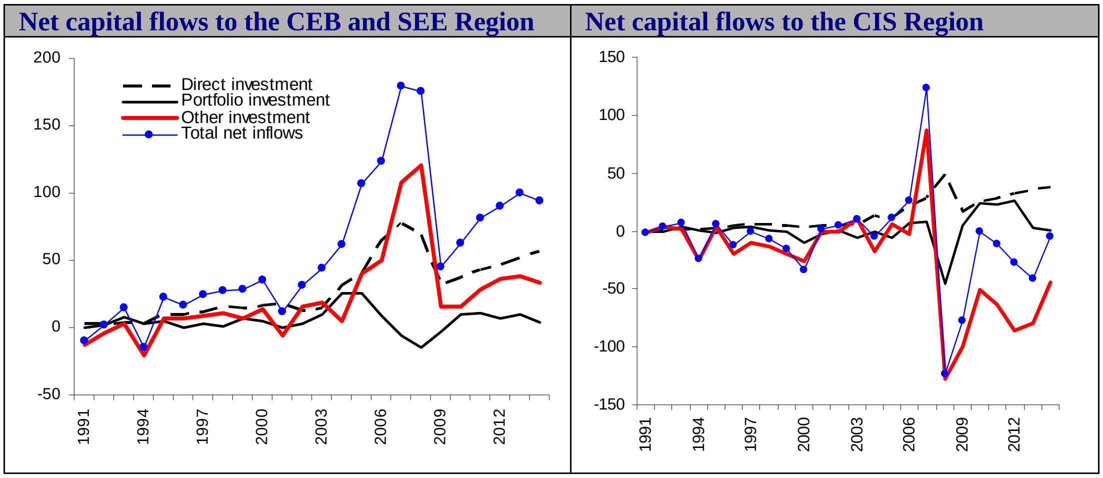
During the crisis, capital inflows stopped and in some cases reversed. While on average the reversal was mild compared with other emerging market regions and previous emerging market crises, some countries – the Baltic countries, Ukraine and Russia – were very hard hit in the last quarter of 2008 and the first quarter of 2009.[14] Furthermore, unlike some other emerging market regions, capital flows have been slow to come back. According to BIS data, after a respite in the second quarter of 2009 the pace of outflows picked up again in the third quarter in Eastern Europe, Russia and Ukraine though this was more subdued in Central Asia and the Caucasus after significant outflows in the first half of the year.

Looking ahead, both EBRD and other institutions expect capital inflows to remain constrained over the next few years. This is driven by a combination of regional factors – in particular, a slower recovery and higher risks compared to other regions – and global factors, which will dampen capital flows to emerging markets worldwide, particularly after monetary policies begin to tighten and excess liquidity from quantitative easing is soaked up by the large central banks. The factors include sharply higher funding needs of governments in advanced countries, implying a much more intense competition for global savings for years to come; and continued pressures on banking systems in developed countries, in light of more conservative attitudes to risk and stricter regulatory requirements. This will result both in permanently lower leverage and a shift of credit away from high-risk asset classes, including much of emerging market finance.

Reflecting these factors, the IMF is expecting net capital flows to the EBRD region of operations to remain well below their 2006-07 peak levels during the 2010-14 period (see figure 3.2).

14 In Russia, a capital outflow of 8% of GDP in the fourth quarter of 2008 wiped out the cumulative inflows of the previous two years.

Figure 3.2: Net capital flows to the EBRD region: 1994-2014
(in US$ billion)



Source: IMF, World Economic Outlook (October 2009).

This decline will impact in particular cross-border bank lending, which is expected to remain subdued relative to levels experienced in the pre-crisis boom, with significant cross-country differences. The CEB region is expected eventually to recover to levels of net lending flows experienced during the 2003-05 period, on account of its close financial integration with advanced countries and the expected continued presence of international banking groups. The CIS countries, on the other hand, are likely to continue to suffer net lending outflows over the medium term.

Portfolio investment is expected to recover faster than bank lending in line with the behaviour of stock prices, but like bank lending it is expected to remain subdued over the medium term, especially in CEB and SEE countries. Net foreign direct investment (FDI) remained positive and relatively robust in net terms through the crisis, and is expected to return to growth this year. This said, FDI is likely to grow at slower rates than over most of the previous decade, as higher risk premia applied to exposures in emerging markets will also raise the costs of capital charged for capital transfers within multinational companies, raising the required marginal return on capital and reducing the scope of viable projects.

In addition to foreign capital, workers' remittances have played a key role in financing residential construction and SME development in transition countries in recent years. Some countries in the CIS showed declines in inflows of between 20 and 30 per cent year-on-year in early 2009 (e.g. Armenia, Georgia and Moldova). Trends over the medium term will be constrained by lower post-crisis growth and weaker labour markets in the EU and in Russia.

In addition to its effect on the volume of flows to emerging markets, global competition for savings will also have an impact on the cost of capital in EBRD countries. The IMF projects a medium term increase in the U.S. long term real bond yield of 2½ percentage points, from an average of about 1½ % points in the pre-crisis (2003-07) period to 4 per cent by 2014. Higher world real interest rates will in turn raise emerging market risk spreads. Using the past responses of emerging market risk premia to U.S. real interest rates as guide, illustrative calculations suggest that the combined effect would be an increase in the cost of capital of an average emerging European country by about 280-350 basis points in the medium term compared with pre-crisis levels.

Scarcer and more expensive international capital will impact private investment and growth in the region through two channels. First, reduced cross-border financing could constrain growth particularly in the natural resource, financial institutions and telecommunications sectors. Second, domestic credit conditions will be supported by foreign funding to a lesser extent than in the past. While this is to some extent desirable – cross-border bank flows exacerbated credit bubbles and other macroeconomic vulnerabilities in the region, particularly during the 2005-2008 boom period – it will also weigh on long-term growth. According to estimates in the 2009 EBRD Transition Report, an increase in capital inflows of 1 per cent of GDP on average raised annual GDP growth by between 0.15 and 0.4 percentage points per year during the 1994-2008 period.

Sustaining rapid growth rates and continued income convergence with advanced countries in a less benign external environment will require both tapping alternative sources of capital – with emphasis on developing domestic capital markets – and invigorated reform and transition efforts that raise productivity growth and support output growth in an environment of scarcer capital.

3.5 CRR4 objectives

Twenty years of economic and political transition have produced impressive results for many of the countries in the EBRD region of operations, but the process of transition is far from over and has become more fragile as reflected in the recent Assessment of Transition Challenges 2009 and the 2009 Transition Report. Experience has shown that transition to well-functioning markets is not a linear process, and the crisis has brought with it important insights into the resilience and sustainability of past transition achievements.

Taking account of lessons learned during the crisis, and as recovery takes hold, albeit precariously, the focus will gradually shift to supporting a more sustainable growth model while deepening market-oriented transition as reflected in the recently adopted strategic orientations for the medium term. One of the main lessons from transition and broader development experience is that private sector development requires institution building in the state as well as in the private sector itself. This was brought out particularly strongly by the crisis in the financial sectors of the region, where weaknesses in both regulation and bank risk management had the effect of promoting expansion at the expense of stability - be it by tolerating excessive currency risks, sector concentration or lack of transparency. But the crisis is also prompting a broader rethink on the need for institutional quality (and not just a reliance on the correcting powers of the market itself) in creating well-functioning market economies in areas as diverse as corporate governance, competition, the legal frameworks for domestic capital markets and energy and environmental management.

As a cross-cutting theme for the CRR4 period, the Bank will therefore reinforce its efforts to improve the quality of market-supporting institutions. It will do so in a manner consistent with its project-oriented nature - the Bank has neither the mandate nor the skills to be a policy-based lender. But within these constraints, the Bank will develop over the CRR4 period a more strategic approach to institutional quality and reform in the countries of operations as part of the strengthening of its business model. One such innovation will be the more systematic pursuit of opportunities for policy dialogue, and the development, where appropriate, of an integrated approach to transition that seeks to purposefully combine projects, policy dialogue and technical assistance in targeting reform objectives. As part of the CRR4 work programme, the Bank is building the capacity to be effective in this endeavour.[15]

The Bank's transition mandate is unique among IFIs in directing it to support systemic change rather than delivering development outcomes. But the choice was, of course, based on the conviction that a democratic and pluralistic market economy is the form of social organisation best capable of achieving results that people care about: meaningful jobs, poverty reduction, higher incomes, high-quality services, a sustainable environment. The Bank's focus on transition, which is "once removed" from these ultimate goals, often makes it harder to judge its impact. The Bank will, during the CRR4 period, continue to reinforce its work in areas, such as the environment, micro-finance and municipal services, in which systemic change and development outcomes are closely aligned.

Regional orientations

The Bank intends to be active across its countries of operations in accordance with its mandate, operating principles, Article 1 of the Agreement and the Bank's Policy on Graduation. The Bank will also pursue during CRR4 the strategic objective of "moving east and south".

The Bank has focused a share of its investments on the region's poorer countries – which tend to be those where the transition process is least advanced – markedly beyond their relative economic size. The CRR3 strategic orientation for the Bank to move "east and south" has reinforced this pattern and will continue to guide the Bank during the CRR4 period. The Bank's ability to operate and be effective in the less advanced transition countries will be further enhanced by a strengthened presence in the field and changes in the organisation of the Bank's corporate work.

Graduation remains a fundamental principle for the Bank. The EU-7 countries were firmly on the path to graduation during the CRR3 period until the global financial crisis hit, threatening to set back the transition process, revealing the fragility of some past achievements and sharply increasing demand for EBRD finance in the form of crisis response. This has delayed the process of graduation but has not changed the Bank's Policy and strategic orientation. On the assumption that global market conditions improve, financial flows return thereby reducing the Bank's additionality, the region

[15] The paper on "Securing recovery and transition with a strong and effective EBRD" sets out possible areas for implementation of such an integrated approach.

recovers in a sustainable way and the threat to transition recedes, the EU-7 countries would be expected to graduate during the CRR4 period, taking into consideration each country's specific circumstances.

Following graduation, the Bank will work with the authorities and companies in graduated countries to actively manage its portfolio. During the early stages of the CRR4 period the Bank will launch a process of consultation with the Board to prepare a strategic, comprehensive approach to post-graduation that is consistent with its mandate.

This will include an approach to business development and opportunities for cross-border trade and investment, promotion of regional cooperation and knowledge sharing between graduated and remaining countries of operations of the Bank in a pro-active but non-discriminatory fashion and consideration of possible further needs of countries that have graduated.

Sectoral orientations

The Bank responded to the crisis by significantly increasing and redirecting its investments. The initial focus has been to help stabilise the financial sector and ensure continued financing for the real economy, balance sheet support for corporates and filling funding gaps for critical infrastructure projects. This priority remains valid as long as the situation in financial markets is precarious and the global recovery is dependent on policy support.

Beyond the crisis, and based on the medium term strategic directions approved by the Board of Governors as part of the CRR4 process and the results of the recent review of transition challenges, the Bank will work on the following sectoral transition business opportunities during CRR4:

- Development of diversified and knowledge based economies providing a basis for balanced and sustained economic growth and employment.

    Demand for financing in the **corporate sector** is expected to rise sharply shifting over time from refinancing to restructuring, mergers and acquisitions and capital expenditure financing. Demand will reflect the combination of pent-up investments delayed by the crisis and lasting scarcity of commercial finance. The Bank will seek to develop the significant food supply potential of the region working through the entire value chain, including agricultural infrastructure and support to upstream agriculture. The Bank will also support the development of a more diverse production structure seeking to reach a broad range of industrial sectors. The scope for energy efficiency gains is significant in this sector due to the energy intensity of a number of industries. Activities in this sector will also support the strengthening of corporate governance and business standards.

- Support for financial sector stability and the resumption of normal conditions of financing for the real sector.

Demand for financing in the **financial sector** is expected to be sustained including for balance sheet strengthening and consolidation. This will require both debt and equity, and will present the Bank with opportunities to promote higher standards in risk management and corporate governance. In conjunction with other IFIs, the Bank will seek to build on initiatives such as the Joint IFI Action Plan to help address regulatory weaknesses. Demand for the Bank's support through credit lines, including for energy efficiency, is also expected to accelerate. As the recovery takes hold, the Bank's support for private equity will be important for SME development, firm restructuring and as a source of risk capital. A particular effort will have to be made to develop the region's local currency money and bond markets, a factor that contributed to excessive forex wholesale funding and unhedged currency positions in the lead-up to the crisis.

- Acceleration of infrastructure, including environmental, investment based on a mix of ownership, management and financing models to enhance the long-term growth potential.

  Investment and transition challenges are coming together in the region's massive replacement of **energy, municipal and transport infrastructure** with significant implications for the Bank for the CRR4 period with an opportunity to assist in building market-based frameworks for infrastructure, one of the least advanced areas of the transition process, and pursue ambitious energy efficiency and environmental objectives. The unfinished transition agenda in this sector combined with high additionality over the CRR4 period is likely to result both in a larger number of transactions, and with more limited syndication opportunities, in larger transactions.

- Shift towards an energy efficient low carbon economy supporting energy security and economic competitiveness.

  While market reforms in many countries now provide price signals to use energy more efficiently, the key challenge is to address the entrenched structures and behaviours that prevent effective responses to market incentives. This challenge is exacerbated by the systemic market failure to monetise and internalise the cost of environmental damage which continues to produce excessive pollution and inefficient energy use. A low carbon economy is an increasingly important element of transition to well functioning markets, where energy resources are used efficiently and market actors face incentives to continuously improve performance. Within this context, and building on the experience established in the Sustainable Energy Initiative, the Bank has considerable opportunities to expand its **energy efficiency and climate change** activities in large energy intensive industries, in energy efficiency financing, low carbon energy production, gas flaring reduction and municipal infrastructure network efficiency.

Reflecting the above geographical and sectoral orientations, the strategic objectives of the Bank during CRR4 are to:

- achieve significant and resilient **transition impact** across its countries and sectors of operations taking account of the implications of the crisis for the region and for the Bank;
- continue to **develop the portfolio "east and south"** with particular attention to Early Transition Countries and the Western Balkans while building up a new portfolio in Turkey;
- promote the development of the **corporate sector** supporting economic diversification and competitiveness, including the region's agricultural and knowledge based potential;
- contribute actively to the stability and development of the **financial sector** in support of the real economy, including the build-up of local financial markets;
- participate in the replacement, upgrading and development of the **energy, municipal and transport infrastructure** of the region; and
- improve **energy efficiency** and contribute to address the **climate change** challenge by supporting the transition to a low carbon economy in the region.

To implement these objectives effectively, the Bank will:

- ensure an active **portfolio management** taking account of higher risks to support transition impact, the build-up of reserves and the efficient use of capital;
- **enhance its business model** building on its comparative advantages and current strengths, including an integrated approach to boost transition impact and active IFI cooperation; and
- develop and implement a **human resources strategy** to recruit, retain and motivate staff with the required skills to work at a high performance level.

The Bank will pursue an active IFI cooperation as this is a particularly promising way to scale up the joint impact on projects, policies and the institutional environment. The IFIs have complementary attributes and capabilities. For instance, there are obvious "economies of scope" in combining the strengths of the World Bank and IMF on policy, the technical expertise and financial capacity of the EIB and the private sector focus and risk-taking of IFC and EBRD in targeting change at the sector level or in the business environment. The strategic review document sets out a broad range of possibilities for improved cooperation. New forms of cooperation on an unprecedented scale have been developed during 2009, in particular in the context of the successful Joint IFI Action Plan for the banking sectors of the region, and in the promotion of reforms in the Ukrainian gas sector (each involving IMF, World Bank Group, EIB and EBRD). The EBRD has actively promoted these initiatives and will seek to build on them in the future, for instance in developing local capital markets.

As part of the preparatory work for CRR4, a review of selected aspects of the Bank's delivery capacity is being performed. The Organisational Capacity Building (OCB) exercise is designed to identify and consider opportunities to enhance the Bank's organisational capacity and relevant processes, the allocation of selected roles and responsibilities and the required skill sets to enable the delivery of agreed objectives.

3.6 Strategic portfolio management

With the approval of CRR2 by the Board of Governors at the 2001 Annual Meeting, the Bank adopted a strategic approach to portfolio management to implement its strategy. This approach states that:

- the portfolio as a whole reflects the transition objectives and operational priorities of the Bank;
- the portfolio is balanced across countries, products and risk categories to achieve transition impact whilst safeguarding the Bank's financial viability; and
- all projects in the portfolio are actively managed throughout their cycle.

In line with this approach, the following elements were taken into consideration in defining and implementing the CRR2 and CRR3 strategies:

- balance transition impact and risk by building a diversified portfolio including a full range of projects varying from higher transition impact/high risk projects to satisfactory transition/lower risk projects;
- build-up a level of performing assets sufficient to cover the administrative costs of the Bank and expected losses and to generate reserves to absorb unexpected losses;
- manage jointly new annual flows and the existing portfolio; and
- focus on asset quality across risk levels.

The strategic approach to portfolio management provides a guiding framework for the formulation and implementation of the medium term portfolio development strategy of the Bank. This approach remains relevant as the Bank defines its CRR4 strategy and continues to pursue the shift of its portfolio to higher risk projects in more challenging business environments while seeking to remain efficient and financially viable.

This section provides a summary overview of the strategic portfolio management issues to be addressed during CRR4 in terms of key strategic management parameters which include transition, portfolio development, risk, profitability and cost. It also mentions the capital management policies and procedures which have been introduced during CRR3 and have become part of the strategic portfolio management framework of the EBRD.

Taking account of trends observed during CRR3 and of its strategic objectives, the Bank will be addressing the following strategic portfolio management topics during CRR4:

Transition

- The project pipeline and portfolio development should be balanced across projects with high transition impact potential and higher transition risk and projects with a lower potential and lower transition risk. This balance allows for additional transition risk in pursuit of potentially higher transition impact while ensuring a stable expected transition impact base level.

- As the Bank intends to pursue and further develop its activity in countries at an earlier stage of transition, the application of a strategic approach to portfolio management in terms of transition impact has the following operational implications:
  - The "Assessment of Transition Challenges" shows that the Bank faces a broad range of transition challenges during CRR4 which provides appropriate scope to sustain implementation of the strategic approach to portfolio management. In particular, it allows the Bank to operate across a broad spectrum of operating and risk environments providing the necessary flexibility to balance transition, financial return and risk.
  - The formulation of clear and realistic transition objectives combined with systematic monitoring and review through TIMS contribute to enhanced transition impact results.
  - The balance of transition rating upgrades and downgrades can be affected by the quality of monitoring on transition conditionality. While the impact of severe reform reversals cannot be compensated for at project level, intensive and focused monitoring with the purpose of optimising the actual transition impact of a project during implementation can influence aggregate expected transition impact trends at the portfolio level. A sustained focus on portfolio monitoring should therefore have a positive impact on expected transition impact.

Portfolio growth

Portfolio and particularly operating assets are important to the Bank for the following strategic reasons:

- The level of Bank activity in terms of investment operations, non-project activities and staff resources is positively related to transition impact. Accordingly, given the above-mentioned focus on transition impact, the level of activity of the Bank is an important element in the achievement of the Bank's fundamental transition objective.
- The Bank needs to maintain a level of performing assets sufficient to cover its administrative costs and build-up reserves to absorb the impact of potential shocks arising from its high risk portfolio. Accordingly, the Bank must maintain an appropriate focus on portfolio build-up, on disbursements and operating assets and on portfolio quality by keeping impairment levels low through appropriate project selection and design and strong monitoring.
- As the Bank pursues its 'moving south and east' strategy, it needs to balance an increasing portfolio in higher risk countries and projects with maintaining a portfolio in lower risk countries and projects.
- The Bank must diversify its portfolio across countries and sectors to avoid excessive concentration. The start of operations in Turkey should provide an important basis to support appropriate diversification in portfolio development.
- The Bank must balance project size across its portfolio. The development of its activities in smaller early transition countries requires the capacity to process efficiently small transactions. Conversely, larger projects are required to achieve systemic transition impact and to support continuing productivity growth. A balance between larger and smaller projects is also necessary from a risk perspective as smaller projects to date have been riskier and more resource-intensive than larger projects.

Risk

- The Bank enters CRR4 in a position similar to CRR2 that is in the aftermath of a major crisis resulting in a significantly higher average portfolio risk rating and impairment ratio than during the preceding period. However, in contrast to the rebound during the early phase of CRR2, recovery during the CRR4 period is expected to be slower.
- In this context, actual country and project risk trends will be major determinants of operational and financial performance during CRR4. In contrast with CRR2 and CRR3 where the Bank operated in a favourable risk context with a number of country risk ratings being upgraded, the operating environment for CRR4 is expected to remain uncertain and volatile in the aftermath of the impact of the global financial and economic crisis on the region of operations.
- Risk is expected to remain significant over the CRR4 period as a result of both the impact of the crisis on the portfolio and of the continuing implementation of the 'moving south and east' strategy. Accordingly, within its operating principles of transition, sound banking and additionality, the Bank should continue to develop a broadly diversified portfolio. Diversification should be achieved in relation to countries, sectors, risk categories and across regions, sectors and investor type within individual country portfolios. Diversification also implies the inclusion of lower risk assets which allow to take increased risks in more difficult business environments within a balanced portfolio approach. Increasing differentiation in risk across countries of operations should allow the Bank further opportunities for balancing its portfolio across a broader range of risk categories.
- A gradual recovery with no major downturn during the period combined with a focus on portfolio asset quality and positive asset recovery activity would result in a rising performing assets ratio, provision reversals, and increased debt and equity returns supporting rising net income and reserves growth.

Profitability

- After a period of high profitability in the first half of the CRR3 period resulting in a rapid growth of reserves, the Bank's profitability was sharply affected by the impact of the financial crisis, particularly on the value of its equity portfolio (see section 2.4). The rise in portfolio impairments during the end of 2008 and 2009 as a result of the crisis has resulted in a negative financial result.
- In the aftermath of the crisis the Bank is likely to confront a more uncertain operating environment expected to result in higher income volatility driven by factors such as interest rates which determine the return on capital, equity market conditions which affect divestment rates and equity gains, and margins which determine debt income. As mentioned above, impairment and resulting provision levels will also play a significant role in determining the financial results of the Bank during CRR4.
- The combination of slower divestments due to the crisis and of continuing equity investments mean that equity operating assets have been rising. While unrealised gains from this stock have dropped sharply due to the crisis, an improvement in equity market conditions in the region could lead over time to a renewed contribution of equity gains to the financial results of the Bank.

Cost structure

- The cost structure of the Bank affects directly financial results and determines, through the budget, the level and deployment of resources in each activity area of the Bank. As such, the cost structure of the Bank influences the delivery capacity of the Bank across cost categories and activities from the banking activity in smaller countries to portfolio risk management, and from the intensity of monitoring to staff incentives.
- The cost base of the Bank is projected to be under significant pressure during CRR4 as a result of staff costs, operational costs linked to small transactions, travel costs, the level of irrecoverable projects costs (for example policy dialogue and integrity checks) and the network of resident offices.
- TC will continue to play an important role both to boost the transition impact of the Bank and to mitigate risks. This activity has cost implications both on operational and support departments as identified in section 5.

Beyond the above parameters, the strategic portfolio management of the EBRD has been further developed during CRR3 with the following capital management policies and procedures:

- As the level of unrestricted general reserves exceeded 10% of the subscribed capital, an annual *net income allocation* procedure was defined and implemented with regard to the 2006 net income. This procedure reflected Article 36.1 of the Agreement Establishing the Bank resulting in a recommendation for approval by the Board of Governors at the 2007 Annual Meeting in Kazan.
- A *Strategic Operations Framework* (SOF) was defined in 2008 to 'provide a stable and predictable medium term capital utilisation framework both for governance, operational and capital management purposes taking account of the new annual net income allocation process and its impact on the operational planning process'. The SOF introduced a set of core management parameters (including sustainability, gearing, capital utilisation, annual business volume and diversification), a Strategic Reserve including governance arrangements and an operating mode 'providing a clear and transparent process for determining reserve requirements'.
- The introduction of the SOF included an *updating of the planning process* with Management providing to the Board each September a review and update of the operational, financial and capital utilisation parameters based on actual performance within the year and an updating of projections for the remaining CRR period. The discussion of the Operational, Financial and Capital Utilisation (OFCU) Update also provides a frame for the definition of the Business Plan for the upcoming year.
- As mentioned in section 2.6, the interpretation of the *gearing ratio* was modified first to an adjusted portfolio basis and then to an operating assets basis. These changes were adopted with a view to increase the capital efficiency of the EBRD while adhering to strong prudential approach.
- Due to higher capital utilisation, the increase in risk in the operating environment of the Bank as a result of the crisis and the increased efficiency of capital utilisation allowed by the changes in interpretation of the gearing ratio, the Bank has developed an Economic Capital Policy which was approved by the Board of Directors on 15

December 2009. This policy establishes a formal framework under which the Bank can prudently manage the risks that it undertakes within its available capital. The Bank's economic capital framework integrates the different risks borne by the Bank with economic capital being defined as the amount of capital required against a type of risk to support potential losses to a specified risk level or solvency standard.

3.7 CRR4 business model

The business model of the EBRD has evolved and strengthened over the years building on the comparative advantages identified in section 3.2, on its core operating principles of transition impact, sound banking and additionality, and on close to 20 years of operational practice, results and lessons learned. The CRR3 noted that the Bank should continue to evolve its business model to adapt its core banking activity to evolving transition challenges, to develop further the competence to address new challenges, to deploy effectively an appropriate level of staffing and resources, and to ensure appropriate controls within a higher risk environment.

Reflecting the medium term strategic directions for CRR4 set out in the document 'Fighting the Crisis, Promoting Recovery and Deepening Transition', the lessons emerging from the crisis and building upon established areas of strengths, the further development of the EBRD business model during CRR4 include:

- an increased emphasis on **policy dialogue** to improve the quality and resilience of transition including institutions, policies and regulations;
- **integrated approaches** across sectors combining **transition focused policy and project work** to achieve systemic changes and progress in the region with potentially higher transition impact and higher volume of operations;
- strengthened ability to operate and achieve transition impact in the **smaller countries of operations,** which is particularly relevant for the ETC and Western Balkans countries, and to cover effectively **regions in large countries of operations**;
- a specific approach to the development of **local financial markets** and the **financial sector**;
- build up the capacity of the Bank to address the growth of the **corporate** sector which is key to sustained transition impact and economic growth and diversification, including a sustained focus on **SME** development, restructuring skills and **knowledge based activities**;
- continuous attention and work at both institutional and project level to develop and implement complex **infrastructure** projects; and
- sustained attention to **risk management** considering higher risk operating environment; and
- work intensification arising from continued focus on smaller countries and on SMEs reflected in continuing growth of the **number of operations**.

The strengthened business model will be more intensive in terms of both local knowledge and resources (staff, budget and funding) with main requirements including:

- a **stronger in-country presence** with higher local knowledge and capability both to support a stronger regional presence in larger countries and operational capacity in smaller countries. A stronger in-country presence also supports the management of a higher number of projects and the intensification of the monitoring process within a higher risk operating environment;
- strengthening and sharpening of **corporate sector skills** with particular focus on general industries and development of agribusiness activity;
- effective articulation and leveraging of HQ and local staff in terms of sector, product and country expertise;
- **skills development** in key strategic development areas such as local capital markets development and sustainable energy;
- develop **restructuring** skills and continued emphasis in **equity** skills;
- **structured approach to policy dialogue** activity by country and sector in direct support to transition investment activity; and
- **strong and predictable TC funding** base to support policy dialogue activity.

In parallel to the CRR4 preparation process, the Bank launched the Organisational Capacity Building (OCB) process to identify and implement a set of measures to improve the efficiency of delivery in specific areas. The focus has been on client service delivery effectiveness and policy dialogue. Within Banking, OCB identified recommendations in terms of country/sector responsibility and matrix operations, the Industry Commerce and Agribusiness sector, equity, the Small Business Investment Committee and portfolio monitoring. A second phase of OCB is identifying measures outside the Banking area.

Going forward the Bank's business is likely to be subjected to increased risk, uncertainty and volatility which require appropriate **controls** in terms of:

- risk management, particularly with regards to the transaction credit analysis and portfolio review function;
- operational risk management and internal controls given the increased volume and complexity of activity;
- compliance and internal audit functions; and
- project evaluation.

As a result, the costs of operational activity are likely to increase due to higher unit costs per project, a larger number of smaller projects, higher provisions, lower recoveries, and higher project attrition during preparation.

Since 2000, the Bank has used an **institutional scorecard** to establish, and subsequently monitor progress against targets and performance areas developed in the annual budget. The EBRD scorecard is defined according to four key performance areas: transition, operational, financial and organisational performance which are covered in this document. The successive formulation of the annual scorecard for each Business Plan will reflect the strategic portfolio management path proposed to achieve CRR4 objectives.

4. CRR4 TRANSITION OPPORTUNITIES AND BANK ACTIVITY

4.1 Transition opportunities and Bank activity

This section describes in an integrated manner transition challenges and opportunities and resulting Bank activities for each region of operations. Within each region, these are presented by main sector of activity including corporate, financial, energy, infrastructure and energy efficiency and climate change.

4.1.1 Eastern Europe and Caucasus

This diverse group of countries was severely affected by the global financial crisis through several channels, including the fall of external demand (in particular, in the EU and Russia), terms of trade adjustment (Belarus and Ukraine), and the collapse of remittances (Armenia, Georgia and Moldova). As a financially very open economy, Ukraine additionally suffered from the sudden reversal of capital flows. Georgia continues to experience shallow investor and consumer confidence, following the 2008 conflict with Russia. After a dip in early 2009, Azerbaijan's commodity-based economy has continued to grow vigorously following the rebound in hydrocarbon prices.

The sharpest growth adjustment is under way in Ukraine, which suffered the blow of a double commodity shock – a collapse in demand for metals, which constitute a large share of Ukraine's exports, together with a rise in gas import prices – while trying to meet large external refinancing needs and stabilise its banking system. It is estimated that the economy contracted by 14½% in 2009 and is only expected to begin to emerge from the deep recession this year, provided the political situation settles after the presidential elections. Although the probability of a "twin crisis" scenario has somewhat receded, rapidly growing NPLs continue to be the key threat to a successful stabilisation of the financial sector.

Belarus and Moldova have been impacted by the crisis as a result of high export dependence on both Russia and the EU. Moldova also shares some of the weaknesses of its SEE neighbours, with twin fiscal and current account deficits, and high external debt. With falling remittances, the country will have to rely on new IMF lending and other bilateral funding for budgetary support. Belarus' ability to cope with the crisis has been supported by a $3½ billion Stand-By Arrangement with the IMF, as well as by financing from the World Bank, China and Russia.

Armenia has seen one of the sharpest output contractions in the region following the fall in remittances and an abrupt end to the remittance fuelled construction boom. Following agreement on an IMF programme, and the floating of the currency, growth should return this year. The recent agreement with Turkey on the opening of the border (if ratified by both parliaments) is a positive signal. The post-war economic vulnerabilities in Georgia are partially mitigated by a generous aid package from a wide range of donors, which is essential to help compensate for the collapse in foreign direct investment.

In the medium-term, the region is expected to converge to the pre-crisis growth potential, under the assumption that capital will flow back and there will be fairly steady reform progress. Greater trade and energy integration with the EU will be the major drivers in the EU-neighboring countries, while higher growth in Russia and the expected rebound in commodity prices will support growth in the Caucasus.

Countries in the EEC region have been amongst the most consistent reformers in recent years, which has created a sense of momentum and has attracted interest of international investors. Progress in reform, as shown by upgrades in the EBRD Transition Indicators and the World Bank’s Doing Business survey, has enabled countries in this region to begin to catch up with more advanced transition countries in other parts of the region. Political changes in some countries, with more reform-minded governments coming to power, have also been propitious. Although EU membership is not a near term prospect, closer economic and cultural ties with the European Union under the Eastern Partnership framework should serve as an anchor for market-oriented and democratic reforms.

However, political stalemate in countries like Ukraine and Moldova have caused the reform process to stall, while the signals on reform appetite in countries like Belarus and Azerbaijan have been mixed. Georgia remains firmly committed to a pro-European, pro-market reform agenda, but recent evidence of instability has limited the capacity for implementation. Regional tensions – including the frozen conflicts in Nagorno Karabakh and Transnistria and along the border with Russia – may interfere with the reform process and undermine the long-term growth prospects for the region.

During the CRR4 period the market transition process in EEC is forecast to continue at an uneven pace. A major reform surge is not part of the baseline expectation for the region as a whole. Prospects for reform in Ukraine are dimmed by the current political uncertainties, which appear structural rather than personal and therefore could take some time to work through. However, the country and its leaders continue to adhere to a policy orientation that favours deeper European and global integration and modernisation of the economy. This will continue to provide opportunities for the Bank to assist in the transition process through its timely lending, policy dialogue and technical assistance in the coming years.

4.1.1.1 Corporate sector

Transition challenges and opportunities

Although some progress has been made in the corporate sectors of this region over recent years, in particular through privatisation and restructuring as well as WTO accession in Ukraine, significant challenges remain in the areas of competition policy, setting up new businesses and bankruptcy procedures, as well as corporate governance and business standards.

In *manufacturing and services* some countries in the EEC region have made further progress with privatisation and restructuring (such as Armenia, Azerbaijan, Georgia and Moldova for example), but effective competition is often lacking, energy efficiency standards need substantial further improvement and the institutional framework remains weak. Hurdles remain in particular in setting up new businesses and bankruptcy procedures, while corporate governance and business standards remain weak across the region. In Ukraine, WTO accession should give further impetus to enterprise reform, although close links between business and politics, weak governance and transparency, as well as significant barriers to entry and exit remain key challenges for the sector.

In the *agribusiness* sector across most countries of the region agricultural markets have been further liberalised and land reform is well advanced. However, productivity and yields in the sector remain low, agro-processors are still largely un-restructured, retail markets are underdeveloped and the sector continues to suffer from limited availability of finance. Although the Ukrainian agribusiness sector has benefited from high levels of foreign investment and recent WTO accession, it continues to suffer from low yields as well as a lack of adequate storage and transport infrastructure. The difficulty of collateralising stored commodities and land poses a further constraint on adequate private financing to the sector.

There are significant opportunities in the development of *property* markets of countries in the region. Although the real estate sector in Ukraine has developed quickly over recent years, investments have mostly concentrated on the capital and other large cities, leaving regional cities underdeveloped. That said, even the main cities are now at a standstill as a result of the crisis. In the remainder of the region the primary property market remains largely underdeveloped. The property sectors of nearly all EEC countries still continue to suffer from a difficult business environment (Georgia is somewhat an exception) and require further regulatory reform.

In the *telecoms* sector, the lack of competition and inadequate tariffs has led to a substantial investment backlog and, in many cases, deterioration in telecommunication infrastructure. As a result, fixed, mobile, internet and broadband penetration rates in EEC countries are lower than in both SEE and CEB countries. Moreover, the quality of regulation remains poor and regulatory independence is often lacking (though Georgia and Moldova have gone further than the others in this regard).

Bank activity

In the *manufacturing and services* sector the Bank's focus will be on improving competition, efficiency and governance standards. The Bank will proactively support the much needed FDI in the region, particularly in the context of potential re-launched privatisations and completion of postponed expansions. The Bank will also pursue investments in local manufacturing enterprises especially with a focus on energy efficiency, knowledge transfer, export-orientation and improved competitiveness. In select cases the Bank will consider working with prominent local Industrial Groups, where doing so would have high transition impact, promote good corporate governance, bring about highly visible improvements to disclosure, as well as improve environmental and energy-efficiency standards. In Ukraine, considerable potential has been identified for re-tooling and promoting energy efficiency upgrades in the steel industry as well as in other areas of heavy and light manufacturing industry. In the Caucasus ETC tools will remain an important vehicle for achieving transition impact and improving corporate governance, transparency and business standards of local enterprises.

To address the transition challenges in the *agribusiness* sector, the Bank will introduce financing schemes that expand farmers' and primary food processors' access to credit. Systemic solutions such as grain warehouse receipts, bills of exchange of rural products (CPRs) and other forms of pre-harvest financing are under consideration. The Bank will also finance bankable projects that address inefficiencies and low productivity in primary agriculture, particularly where up-to-date farming techniques and machinery can be introduced. The Bank will continue to support sponsors who are able to address global food security by increasing agricultural output and exports through productivity gains. In Ukraine, support will be provided for the modernisation, expansion and restructuring of corporates throughout the value chain, with an emphasis on regional investment. Investments in agricultural infrastructure (e.g. port terminals, storage facilities or shared environmental facilities) and upstream agriculture through vertical integration will be considered. In less advanced countries/ETCs, attention will be given to projects principally with domestic companies to improve enterprise efficiency and corporate governance standards. Policy dialogue will be developed with Ministries of Agriculture, particularly in the grain and dairy sectors to address some of the pressing issues affecting the sector.

In the *property and tourism* sector, the Bank will support the development of regional logistics, retail, office, mixed-use and hotel facilities by provision of long term debt and/or equity. As a response to the crisis, the Bank will support financially viable projects whose development has been interrupted by a deficit in financing with the ultimate aim of restoring the region's real estate markets to activity and liquidity. The Bank will also work with small/local sponsors under DIF / DLF and MCFF mechanisms in Caucasus and Moldova. The Bank will engage in policy dialogue linked to its project financing to assist development of appropriate institutions and regulatory standards.

In the *telecommunications* sector, the Bank will focus on financing broadband and mobile telephony deployments in the region through more regional consolidation investments, new entrants and the expansion of alternative providers. The region also requires more regional backbone networks. By financing critical links and aggregating hubs, the Bank will promote competition. Providing investment and structural reform for digitalising broadcasting networks is another focus. With the EU having set a goal of achieving digital broadcasting by 2012, surrounding countries reliant on EU programming and transmission will need to upgrade their broadcasting networks and implement new regulations.

4.1.1.2 Financial sector

Transition challenges and opportunities

Transition challenges in the financial sector in Ukraine, the largest country in this region, remain significant in both *banking* and *non-bank FI* sectors. While very strong capital flows to the sector resulted in rapid credit expansion up to mid-2008, the crisis has also exposed important weaknesses in the system particularly in risk management in banks and central bank supervision. *Insurance* legislation and regulation have improved in recent years, though the pension system is yet to undergo major structural reform.

Lending to *MSMEs* suffered during the crisis, as did trade finance, as risk aversion increased. The institutional environment for MSME lending needs substantial strengthening. Progress has been made in *securities* legislation, although enforcement remains poor, and a viable private equity industry is only gradually developing. Despite large issuance in equity and private bond markets, market liquidity remains very thin and domestic institutional investors near-absent, undermining the potential of market-based finance.

In the five other countries of the EEC region, financial sector transition gaps are predominantly large, with particular challenges in creating a sound institutional and policy framework for the banking system. There has been some improvement in Georgia's banking regulation; however, regional turmoil and the international financial crisis both led to a dramatic slowdown in bank lending and serious vulnerabilities have since been exposed, in particular with respect to the need for improvement in risk and portfolio management.

Opportunities for the further development of *MSME* finance exist in all countries in the region, as there are still low levels of financial depth amongst MSMEs, which tend still to seek alternatives to bank loans to finance investment and working capital needs. The lack of efficiently operating and comprehensive credit information services for smaller loans and weak legal frameworks for enforcing collateral and bankruptcy procedures is a clear impediment for MSMEs access to finance. Competition among the MSME lenders needs to be enhanced, especially in rural areas. As in other less advanced transition countries, commercial *private equity* firms are absent, and with a few exceptions there has been only very limited interest by international private equity funds. A challenging business environment, limited investment opportunities and poor exit prospects all limit the possibilities to raise finance through this channel.

Bank activity

The Bank will continue to focus on crisis response activities that address the legacy of the crisis in the region. The Bank will participate in balance sheet restructuring and re-capitalisation of banks in order to help banks to cope effectively with increases in non-performing loans (NPLs). Additional capital support will be provided to those banks likely to be successful providers of financial services in the medium term.

In Ukraine, there will be systemic support for the financial sector through proactive engagement with clients to improve corporate governance and promote prudent business and risk management practices. The Bank will be available to participate in selected restructuring opportunities and will promote sector consolidation. The Bank will continue to coordinate with other IFIs and engage its foreign strategic partners to ensure delivery of effective response programmes.

The availability of financing for trade is an essential element in responding to the financial crisis and in accelerating the recovery process. The TFP will be an important product throughout the region, providing vital finance to banks to support trade activity, especially in light of reduced access to trade finance facilities from international banks, insurance underwriters and export credit agencies.

To help restore lending to the real economy, the Bank will continue to promote sustainable MSME financing through the availability of product focused credit lines channelled through local financial intermediaries. The Bank will also offer products that address banks' reluctance to take risk. Risk sharing mechanisms, including extended use of MCFF, will be important to enable banks to provide finance to their clients whilst prudently managing credit exposures.

Sustainability and stability of financial systems requires the development of sufficiently robust local markets to channel savings and investments in an efficient manner and to support well functioning local currency markets. The Bank can play a significant role through policy dialogue, TC, investment and its own Treasury activities to stimulate and support long term development. Key areas for investment include institutions to encourage long term savings such as insurance and pension funds.

The Bank will also investigate opportunities for investment in local financial infrastructure – including in basic utilities that would be key building blocks for the development of local financial markets and local currency lending.

There will be focus on equity funds that have an investment strategy targeting SMEs in order to provide much needed capital for growth. The Bank will also support funds focusing on turnaround situations, or enterprise restructuring to accelerate recovery in the region.

The Bank will also build on its ongoing policy dialogue working with the authorities in the post crisis period to move transition forward in this sector.

4.1.1.3 Energy sector

Transition challenges and opportunities
There are very significant transition challenges in the EEC countries' energy sectors, where the private sector plays a very limited role, restructuring is at a very early stage and the regulatory framework is underdeveloped. Armenia and Georgia, and to a lesser extent Azerbaijan, have made some progress since 2005, and transition gaps have narrowed somewhat in MEI, transport and sustainable energy. In Ukraine and Belarus transition challenges remain large across all sectors.

In the *power* sector, some unbundling and private sector entry has occurred in Armenia, Georgia, Moldova and Ukraine, but further efforts are needed to the rehabilitate the ageing infrastructure, particularly the power transmission networks, to promote regional integration, increase energy efficiency and bring new generating capacity on stream, including renewable sources. Institutions are weak across all countries in the region and there is need to reinforce the independence of the regulators, promote transparency and competition, and ensure full cost-recovery-based tariffs with adequate support for the poorest consumers. In Azerbaijan and Belarus the power sector remains vertically integrated, with no private sector participation, and with weak regulatory frameworks and tariffs set at levels well below cost recovery.

In *natural resources*, challenges remain significant across all countries in the region, including the most resource rich country Azerbaijan. Oil and gas receipts are estimated to account for over 70% of Azerbaijan's exports and nearly 50% of budget revenues. The key challenge for the country is the restructuring and commercialisation of SOCAR, the main government vehicle accounting for around half of domestic oil production. In Ukraine, a net oil and gas importer and a transit country to Europe from Russia and the Caspian region, little progress has been made in tackling some of the key structural reform issues in the energy market, such as unbundling and corporatisation of the oil and gas monopoly Naftogaz Ukraine (NAK). NAK and its subsidiaries continue to dominate the upstream oil and gas sector.

Bank activity

In Ukraine the Bank will support the government's privatisation and energy sector reform programme (market and tariffs in particular) through both direct investment and policy dialogue. The Sustainable Energy Action Plan (SEAP) and/or integrated approach will be used as references. The Bank will finance transmission projects, to reduce bottlenecks and increase efficiency, particularly in light of Ukraine potentially joining ENTSO and the Energy Community, which will bring Ukraine's energy sector into Europe and Southeast Europe regionalisation. It will also support rehabilitation and greenfield generation projects, particularly in renewables for large and small projects. The recently Board approved Ukraine Renewable Direct Lending Facility should provide an important impetus for small projects which normally fail to get financing.

In the Caucasus, the focus will be on regional cooperation to facilitate trade with neighbouring countries (Turkey in particular) and to develop substantially small and medium renewable projects, focusing on hydro. Given the large investment needs in this area, it will also be important to try to bring private sector investors. In Moldova, the Bank will support regional integration and entry into ENTSO and the Energy Community through policy dialogue and direct investments. Investments in generation should focus on reducing dependence on imports and increasing efficiency.

In *natural resources*, engagement will be pursued with the Government of Ukraine and NAK Naftogaz and with IFIs for the reform of the Ukrainian gas sector and NAK as conditions for a longer term finance facility to support infrastructure modernisation and development. Policy dialogue will be developed to improve the structure, efficiency and transparency of the oil hydrocarbon sector, supported by associated financing. The Bank will also support policy and projects to improve safety in the Ukrainian coal sector including through financing of new projects (particularly where these promote improved health and safety standards) and privatisation initiatives in the sector. Attention will be given to the independent oil and gas sector for increased competition and industry efficiency. In the Caucasus, the Bank will aim to address significant transition challenges through infrastructure, environmental, safety and energy efficiency projects in the hydrocarbon sector.

4.1.1.4 Infrastructure sector

Transition challenges and opportunities

In *MEI*, there are major challenges across all municipal services to rehabilitate physical infrastructure, accelerate tariff reform and restructure to improve efficiency, including energy efficiency. Municipal services have been decentralised in Armenia, Moldova and Ukraine, but financial and operational performance remains weak and access to finance has been severely curtailed in the aftermath of the crisis. Decisions on operations and investment remain under the control of central governments elsewhere in the region. Tariffs are below cost recovery levels and collection rates are low in some of the least reformed countries (e.g., Azerbaijan and Ukraine). Demand side measures – such as metering – have been introduced in only a few countries. Across the region private sector participation is limited to urban transport.

In *transport*, the three Caucasus countries have made more progress in separation and unbundling of railways, tariff reforms and increased private sector participation (less so in Azerbaijan), but significant challenges remain in the areas of restructuring, commercialisation and transparency. In Belarus, Moldova and Ukraine unbundling has not yet occurred in the railway sector, and the operating and policy setting functions are not separated and core railway businesses (infrastructure, passenger, freight, etc.) are operated by the same state-owned entity. Some progress has been made in the roads sector in terms of divestment in motorway management and maintenance and conversion into joint stock companies, but private sector participation is limited.

Bank activity

The Bank will seek to address a wide range of transition challenges in the MEI sectors of the region, including though rehabilitating infrastructure, restructuring services and promoting tariff reform. In *MEI* in Ukraine, the continuing crisis can be expected to have a long term impact making the Bank's role essential in responding to the lack of available financing. Energy efficiency investments will be at the forefront of the Bank's efforts in close coordination with donors (such as the Sweden-sponsored Energy Efficiency and Environment in Eastern Europe Partnership) and IFIs and leveraging policy dialogue efforts to facilitate the district heating sector reform. Strategic investments in clean urban transport modernisation will also contribute to high quality public services and reduction in the energy intensity of the economy.

In MEI in the Caucasus, the Bank will work closely with other IFIs and international donors to further reform the water sector through a series of investments. Small scale investments in the public transport sub-sector will be sought in principal cities, to provide greater modal choice. Consolidation of smaller municipalities and regionalisation will ensure long term sustainability as well as enable finance in smaller municipalities, resulting in improved service levels.

In transport in Ukraine, there is potential to support further private sector participation in the development of port infrastructure. Financing of concessions could also be envisaged towards the end of the period particularly for regional airports and roads. In the nearer term, opportunities exist for continued sovereign infrastructure financing in the road sector. Subject to concrete steps being taken to corporatise Ukraine Railways, further sovereign financing of railways can also be anticipated as well as non-sovereign financing of commercial activities such as freight operations, for which modernisation of the railcar fleet is needed. The Bank's involvement in the port sector would encourage the establishment of the proper landlord model, where the port infrastructure is owned by the state and superstructure and operations are fairly tendered and run on a commercial basis.

In *transport* in the Caucasus, opportunities to finance infrastructure on a commercial basis will emerge in Georgia, including support for the expansion of privately owned port terminal facilities in Poti Port and the financing of rail infrastructure on a non-sovereign basis. Similar non-sovereign support may also be extended for investment in air navigation equipment. The Bank will also support the privatisation process of Poti Port. In Azerbaijan and Armenia, opportunities are likely to be more limited, but may involve sovereign financing of road infrastructure and/or rail infrastructure.

4.1.1.5 Energy Efficiency and Climate Change

Transition challenges and opportunities

Energy tariffs are very low in some countries (Azerbaijan, Belarus and Ukraine) and progress in enterprise restructuring has been slow, meaning that energy efficiency challenges remain huge, particularly in the industrial sector. Tariffs in all countries in this region do not reflect environmental costs. Armenia is the only country with targeted policies for renewable energy, but in general the policy and legislative framework across the region is underdeveloped. Ukraine ranks among the three most carbon intensive countries among all parties to the UN Framework Convention on Climate Change (UNFCCC), and energy intensity levels throughout the region remain very high. Remaining challenges include the need to further develop institutional capacity, to further increase tariffs to encourage energy savings and to further develop the legal framework for renewable projects.

Bank activity

The key focus in the region will be on supporting increased energy efficiency through sustainable energy investments. Ukraine will be an important country for the Bank to focus on due to the high energy intensity of its economy, the resulting absolute level of carbon emissions compared to other countries in the region, and the severe issues of energy security to which Ukraine is particularly exposed. The interaction of these three factors has positioned Ukraine to be the target of significant concessional and market-based climate funding which will support, *inter alia*, the development of Bank sustainable energy activities in Ukraine. Policy dialogue with Ukraine will be focussed on developing the relationship with the Ukrainian authorities in the context of the SEAP.

In the other countries of the region, the overall aim of technical assistance throughout CRR4 will be to create a supportive environment for sustainable energy investments, and depending on the opportunities and potential the Bank will develop further SEAPs in the region. The Bank also aims to develop city-based SEAPs in the context of the EU Covenant of Mayors initiative, as new instruments to enable cities in the region to move towards a cleaner energy future. SEFFs will be renewed where they are already in operation, and also be broadened in terms of their reach into new sectors such as buildings, renewables, and SMEs, where these are not already covered. The Bank will introduce the SEFF instrument in new countries in this region during CRR4. The Bank will take advantage of the projected fuel price increases in the important transit countries of this region to promote industrial energy efficiency, both through direct investment and through financial intermediaries. Efforts will be made to support tariff and regulatory reform. The Bank will also use the emerging concessional climate finance streams that are of particular importance to this region. This will include the development and implementation of Clean Technology Fund (CTF) financed projects in Ukraine, and the development and implementation of Eastern Europe Energy Efficiency and Environment Partnership (5E) initiative supported projects in Ukraine and other countries in the region if E5 is extended beyond Ukraine.

4.1.2 South-Eastern Europe

The extent of the decline in the eurozone – the main export market – combined with domestic weaknesses led to sharply negative growth in 2009 in the main economies of the region – Bulgaria, Romania and Serbia – with a modest upturn expected in 2010 in all cases except Bulgaria. The smaller economies of the region were less exposed to the credit crisis but still have significant vulnerabilities and all experienced recession in 2009 except Albania.

Lending from western parent banks to their subsidiaries in the region held up in 2009, supported by the 'Vienna Initiative' in countries with IMF programmes (Bosnia and Herzegovina, Romania and Serbia), but may be subject to further stresses if economic conditions deteriorate. Currency and banking crises have been avoided to date, but both currencies and bank balance sheets may come under further pressure if governments fail to keep the fiscal accounts under control. All countries in the Western Balkans rely on substantial remittance flows, which declined in 2009 (given the recessions in the main host countries in Western Europe) but still help to cushion the negative effects of lower FDI and parent bank financing.

In recent years, South-eastern Europe has been at the forefront of transition-oriented reforms. Despite this progress, several Western Balkan countries continue to lag behind in transition, reflecting their late start to the process. Countries in SEE are expected to continue to catch up in transition and to accelerate reforms post-crisis. The most important reform driver is the EU approximation process and prospect for future membership. The two existing members – Bulgaria and Romania – have committed to continue to pursue vigorous reforms in a number of areas, including strengthening state administration, enforcing competition and combating corruption. The remaining countries have all signed Stabilisation and Association Agreements with the EU and are actively pursuing the ultimate goal of membership. This will require a sustained commitment to reforms along the way. Another key reform driver is regional integration. All countries in the region now cooperate among themselves to a much greater extent than previously, for example through initiatives such as the regional trade agreement (the so-called expanded CEFTA) signed in 2006 and the regional energy community. This helps to create a more attractive investment environment and will help in attracting substantial inflows of FDI once global investor appetite returns.

However, there does remain a risk that some of the incentives for reforms will be diminished post-crisis. The pull of the EU will be greatly reduced if it appears to non-members that their prospects of full membership are too far away. Some political turmoil stemming from inter-ethnic tensions could re-occur in the region. Cross-country surveys continue to show the pervasive problems of corruption, limited administrative capacity and a weak business climate. Any failure to address these problems would deter investment and depress growth prospects.

4.1.2.1 Corporate sector

Transition challenges and opportunities

The remaining transition challenges in the corporate sector in South-eastern Europe are mixed, with more moderate challenges remaining in the most advanced countries in the region – i.e., Bulgaria and Romania – but significant challenges in the Western Balkans, particularly in the agribusiness, general industry and property sectors.

Most countries in the region have seen an improvement in their *manufacturing and services* sectors. In Bulgaria and Romania, privatisation is almost complete and legal and regulatory standards have been aligned with EU standards. Remaining challenges concern enterprise restructuring, increased energy efficiency for competitiveness and further improvements to business standards. In the Western Balkans, there has been some progress with privatisation and restructuring, although this is yet to be reflected in improved efficiency and productivity. Regulation is gradually being aligned with EU norms, but there remain large differences between the quality of laws on the books and their application in practice.

In the *agribusiness* sector, the privatisations of farms are complete. However the development of efficient private farms remains a challenge due to unclear property rights, significant land fragmentation and the lack of an active land market. Restructuring and further improvements in quality and hygiene standards in food production are still needed. Retail is not very developed yet, except in Bulgaria and Romania. Private sector banks still show limited interest in servicing the sector and this is being exacerbated by the current crisis. Bulgaria is the only country in the region that has a functioning warehouse receipts programme, although Serbia is developing the necessary legislation.

In the *property and tourism* sector, the primary real estate markets in Bulgaria and Romania are well developed, but in regional cities/areas some segments of the market remain underdeveloped. In the Western Balkans, there is still an under-supply across most sub-sectors of the primary market. Moreover, tourism assets across the region are typified by poor surrounding infrastructure and low quality of stock, though governments across the region, in particular in Montenegro, have significantly invested in the tourism sector in recent years. As a result of the crisis the whole region faces a severe liquidity shortage (in both debt and equity) for property development. Liquid secondary markets are largely nonexistent in this region. Further institutional improvements are required across the non-EU member states in SEE, since in a number of cases ownership rights remain difficult to establish while land registration and building permissions are unduly cumbersome.

In the *telecoms* sector, mobile, internet and broadband penetration rates are lower in SEE than in more advanced transition countries. Telecommunications infrastructure in rural areas is particularly poor. Although harmonisation with EU regulatory and legal standards has been progressing, in most countries further work is needed to implement international best practice and strengthen the implementation capacity of regulatory authorities. Due to high interconnection prices and lack of liberalisation, competition in provision of telecommunication services outside of the mobile segment is generally low.

Bank activity

In the SEE region Bank activity in the *manufacturing and services* sectors will particularly focus on improving efficiency and corporate governance standards and support restructuring (including consolidation). In the Western Balkans, corporate business activity will be driven by local market growth and local companies due to limited prospects for FDI and exports. The existing Local Enterprise Facility will be the main vehicle to deliver projects of up to €10 million, especially in view of increased demand for working capital needs, balance sheet restructuring and equity strengthening from local enterprises. In Bulgaria and Romania, the corporate sector is expected to consolidate as a result of the crisis with the share of larger enterprises rising and weaker companies disappearing. Investment needs are expected to increase in the recovery phase both for local companies and new investment from foreign strategic sponsors.

Activity in the *agribusiness* sector will target market leading local agriculture processors and food distributors in the Western Balkans that require assistance with their domestic and cross-border expansion plans and/or compliance with EU quality and governance standards. The Bank will also pursue the development of the Warehouse Receipt Programme framework in Croatia and Serbia, and continue to utilise the Local Enterprise Facility to support growing small to medium sized agribusiness companies. The Bank will adopt in Romania and Bulgaria a similar approach to that used in Central Europe (see section 4.1.5.1) and support bankable projects in environmental sustainability as they occur.

Activity in the *property and tourism* sector will selectively support the development of regional logistics/industrial parks, retail, office and mixed-use facilities by provision of long term debt and/or mezzanine and equity instruments to contribute to the reduction of regional inequalities in the economic development of SEE. As a response to the crisis, the Bank will also provide support to situations of distress and facilitate the completion of commercially viable projects. The focus will be on projects supported by strong and experienced sponsors and with high energy efficiency standards. The Bank will also selectively consider tourism projects, including mid range hotels and contribute to the creation and deepening of secondary markets by participating in sector specific equity funds. The Bank will continue to use its investments to identify and address shortcomings in the institutional environment for property development and promote the highest standards in business integrity

In the *telecommunications* sector the Bank will focus on financing broadband deployment in the region through more regional consolidation investments and the expansion of alternative providers. The Bank will continue to promote energy efficiency measures with basic telecom infrastructure. Given the increasing number of technology firms and the lack of risk capital, the Bank will also be investing into equity funds and equity to promote innovation. The Bank will provide investment to address the gap in the digitalisation process of the national broadcasting networks. Given very high dependence on EU programming and short-term EU cutover dates, the region will have to be prepared for digital broadcasting. Investment for competitive postal services is another important area.

4.1.2.2 Financial sector

Transition challenges and opportunities

Financial sector regulations and institutions in Bulgaria and Romania have come into alignment with EU standards, though implementation still needs to become more effective in many instances. In all countries the international financial crisis has revealed the *banking* system's vulnerabilities brought about by rapid credit growth. Banking supervision did not fully respond to the challenges posed by rapid market development, inflows of foreign credit and foreign ownership in the sector.

There are still significant transition gaps in *MSME* finance throughout the region. Financing is limited in rural areas and outside major cities, and for small agricultural enterprises. The development of local money and bond markets remains an important objective in Serbia and Romania, where uncertain integration into the eurozone will continue to pose currency risks for the foreseeable future and local liquidity is large enough to support local markets. Commercial private equity remains in its early stages, and the region has so far not attracted substantial interest from international private equity funds.

Securities markets legislation is consistent with EU standards in Bulgaria and Romania, but turnover is low even in the relatively well-capitalised markets in the largest SEE countries, limiting public equity as a viable method of raising capital. There is a clear lack of venture capital type funding throughout the region. Local currency money and securities markets remain underdeveloped, thereby locking in the already high currency substitution in these economies.

Bank activity

The Bank will continue to address the legacy of the crisis through equity investment and balance sheet restructuring. Following the success of the Joint IFI Action Plan, the Bank will continue its close collaboration with other IFIs so that actions are coordinated and each institution's competences can be deployed to deliver response programmes. In this context, the Bank plans to continue to implement comprehensive project packages with strategic partners who are active in the region.

MSME financing through financial intermediaries will be a key component to the Bank's crisis response in this region. As this sector is the driving force of many economies, it will be vital to maintain access to finance for long term sustainability, directed through banks and non-bank financial institutions that will extend outreach to rural areas. TFP, specifically in the Western Balkans, will remain an important tool for providing finance to the real economy and facilitating trade as the economies recover.

The Bank will continue to support energy efficiency financing throughout the region. It is a priority product that is enabling partner banks to diversify their lending portfolio whilst developing a new business segment.

Sustainable financial systems will require better mobilisation of domestic savings and attention to the development of local capital markets and local currency lending. By supporting local financial infrastructure, such as credible deposit insurance systems, the Bank can assist this development. A key feature of sustainable local markets will be the development of credible long term savings vehicles, including insurance companies, pension funds and asset management companies. This will require a combination of policy dialogue, TC and investment. The Bank will also seek to promote local currency lending with clients and support improvement in conditions that make local currency debt financing attractive to both lenders and borrowers.

The Bank will play an important role in the private equity industry by attracting institutional investors and supporting existing and new local fund managers. New projects in collaboration with other IFIs, such as the Jeremie programme with EIF, will be pursued to provide capital to small enterprises and venture capital initiatives.

4.1.2.3 Energy sector

Transition challenges and opportunities
There are significant transition gaps in the energy sector in the SEE countries, although Bulgaria and Romania are closer to the standards of the most advanced transition countries. The largest challenges remain in Serbia and in the smaller countries of the Western Balkans, especially in Bosnia and Herzegovina and Montenegro.

In the *power* sector, liberalisation and private sector participation in both distribution and generation has progressed and the quality of market-supporting institutions is generally good in Bulgaria and Romania, though transition challenges are pronounced elsewhere. The Bosnian, Montenegrin and Serbian power sectors are still vertically integrated, state-owned, and only partially unbundled. Efficiency and transmission/distribution losses remain high everywhere and there is need for investment to rehabilitate old generation capacity and exploit the region's renewable potential. Regulators are not fully independent and affordability constraints to tariff reform remain. Regional integration through participation in the SEE regional electricity market and approximation with EU directives are key challenges ahead.

In *natural resources*, energy security and diversification of energy sources is a key priority as highlighted by the temporary cut-off in gas supply to the SEE region in

January 2009. Further development of the gas infrastructure network and reform of the gas sector to bring it into line with EU directives on liberalisation and third party access is a key priority for countries in SEE. Full unbundling of regional oil and gas companies still operating in the region, i.e. Serbia, is a challenge ahead. The region is also rich in coal and other metals but the sectors suffer from lack of transparency and little private ownership.

Bank activity

In *power and energy,* the Bank will focus on regional integration and energy security, supporting transmission interconnections, and platforms for cross-border trading, upgrade the stock of traditional power capacity and support renewable energy projects to improve security of supply. In doing so, the Bank will invest in privatised companies to support market unbundling, privatisation and liberalisation. Romania will require significant investment to replace old and depleted generation infrastructure. Transmission interconnections also remain important to improve efficiency and support the regional market. The Bank will finance these as well as renewable energy projects to support the new renewable framework and help the country meet its renewable energy targets. Financing of renewable energy projects will also help Bulgaria meet its renewable energy targets. In addition the Bank will focus on financing investments in transmission and distribution networks that improve efficiency together with investments in new interconnections with neighbouring countries.

In *natural resources,* the Bank will support regional oil and gas pipelines, and related infrastructure to address energy security issues as well as increased gas storage facilities to help meet energy security and EU regulations. Consideration will be given to mining, ore and metal processing and coal projects which can be conducive to economic growth.

4.1.2.4 Infrastructure sector

Transition challenges and opportunities

Municipal services have been decentralised and corporatised in SEE but financial performance is generally weak and, with the exception of Bulgaria and Romania, private sector participation is limited. In most towns, water and heat tariffs remain below cost-recovery levels. Regulatory arrangements are well below international standards and regulatory performance is uneven, even in Romania, one of the few transition countries with a national water regulator. The key challenges in the MEI sector are effective implementation of a transparent tariff setting methodology, improved contractual arrangements to foster the commercialisation of municipal services and achieving greater regulatory autonomy.

In *transport*, the region has major investment needs to upgrade roads, railways and ports. The key transition objectives are to accelerate progress in restructuring – institutional separation of infrastructure from operations – and to improve the legal framework for PPPs and concessions, which would assist in attracting the private sector where possible as a co-investor or operator in selected projects. There are a number of potential motorway PPP opportunities in Romania and BiH.

Bank activity

In Romania and Bulgaria, the key objective in the *municipal* sector is to consolidate sector reform, notably for regional water companies, as well as to assist small and medium municipalities while facilitating EU fund absorption. Wastewater will remain a key focus to enable the Bank to meet its environmental mandate and the ability to structure projects which utilise grant financing will be a key focus. In addition to ongoing work with local authorities and water companies, the Bank will also explore industrial wastewater projects. The Bank will continue to promote improved regulatory and contractual arrangements for water-, waste- and urban transport operators to facilitate private sector financing and operation within these sectors. Energy efficiency in public buildings and housing will be further explored with projects structured as both direct loans to municipalities (EU Elena facility) where commercial principles can be strengthened as well as the ESCO concept. Finally the Bank will continue to roll out projects based on performance-based multi-year road maintenance contracts with the private sector.

In the Western Balkans, the underdeveloped municipal sector has strong potential but faces long development times and a large need for TC due to inefficient decentralised fiscal regimes, weak regulation and tariff settings and the financial weaknesses of local administrations. The Bank will endeavour to implement a sub-sovereign lending approach but retaining the option to follow the sovereign route where necessary reforms cannot be implemented or the borrowing costs on a sub-sovereign basis would exceed affordability limits. Priority investments will be in the environmental (e.g. water and wastewater, solid waste) and energy efficiency (notably biomass) sectors as well urban transport modernisation through the enhancement of Public Service Contracts to conform to EU directive 1370 and rolling out of long-term performance-based road maintenance contracting. In Serbia, the Bank will seek to establish sub-sovereign lending across the country, and notably beyond Belgrade. Key sectors would include the urban transport sector (road, rail, bridges, and traffic management) and environmental projects. Generally in the region, providing financing to small and medium-sized municipalities in a cost effective and efficient manner continues to remain a challenge and the Bank will build on the experience from the Bulgarian FLAG to expand this concept in other markets.

In Romania and Bulgaria, plans to finance development of road infrastructure on a PPP basis potentially provide opportunities for the Bank to support private sector participation in the development of *transport* infrastructure. In the Western Balkans, on-going demand and opportunities are anticipated in transport infrastructure, with financing mostly on a sovereign basis. The new Western Balkans Investment Framework with EIB and EC will provide a platform to consolidate funds at the European level. In addition, opportunities may emerge to finance selected projects on a concession basis, such as the development of port terminals and airports.

4.1.2.5 Energy Efficiency and Climate Change

Transition challenges and opportunities

The legal and institutional framework for sustainable energy in Bulgaria and Romania is well developed and regulatory incentives for renewable energy and energy efficiency are in line with EU Directives, though energy intensity and renewable energy penetration are still lagging behind the EU average. The legal and institutional framework for sustainable energy is underdeveloped in all Western Balkan countries and implementation capacity is low. Despite the introduction of feed-in tariffs and off-take obligations in most countries the penetration of renewable energy projects is hampered by the unstable legal framework and weak enforcement of grid access. Energy efficiency projects are hampered by institutional barriers and low tariffs.

Bank activity

A major objective will be to support the region to get closer to EU 2020 targets and inclusion in the EU Emissions Trading Scheme. The Bank will be leveraging EU funding for climate change mitigation using structural funds to support investment in New Member States and pre-accession programmes in the Western Balkans. Furthermore, as climate change adaptation issues are more urgent in this region, work to make investments more climate change resilient will proceed – primarily in the areas of water usage and hydropower. Accordingly, the region will become a trial region for the operationalisation of adaptation within Bank investment programmes. SEFFs and the establishment or operationalisation of dedicated Funds will be pursued throughout the region. The Bank will further deepen the sector reach of SEFFs in Romania and Bulgaria and put a focus on demonstrating the model in the Western Balkans, before broadening the scope of SEFFs and applying them to new markets. Furthermore, the Bank will develop and support the development of new approaches to sustainable energy finance such as the proposed Western Balkans Municipal Fund. In industry the main impact is expected to be from streamlined instruments like the Direct Lending Facility for energy efficiency and smaller renewable investments will be used to enhance industrial energy efficiency while engaging with specific large energy users for direct financing. In terms of policy dialogue, the Bank will develop the existing relationship with authorities in the context of the SEAP with Bulgaria, and also in the Western Balkans. This will be supported by developing a strengthened relationship with the EU Commission to ensure close co-ordination and continued access to existing and new instruments for the support of clean energy and adaptation investment.

4.1.3 Central Asia

The most severely affected country in Central Asia is Kazakhstan, where an economic contraction of -1.3% is estimated for 2009 with a projected return to positive growth in 2010 of 3.5%. The country is slowly recovering due to the massive fiscal stimulus and looser monetary policy. Economic dynamism is constrained by a lack of fresh bank lending, as large banks continue to struggle with reducing their debt burdens, either through restructuring or repayments. The main risks to the modest economic recovery lie in a reversal of the oil price, which would put renewed pressure on the exchange rate. In addition, banks will shift restructuring efforts from the liability to the asset side of their balance sheets. This may put further pressure on the real economy, as bankruptcies increase and unemployment may rise.

Most of the smaller CIS countries in Central Asia avoided contraction in 2009 but growth decelerated significantly due to lower commodity prices and the recession in Russia, which has impacted remittance flows to all countries. In the two relatively isolated countries of Turkmenistan and Uzbekistan, growth has exceeded 6 % per annum. The Mongolian financial system remains fragile with very rapidly increasing non-performing loans. A slight upturn in growth in Mongolia**,** the Kyrgyz Republic, Tajikistan, Turkmenistan and Uzbekistan is expected in 2010 under baseline global assumptions.

Further progress with transition could unleash significant additional growth in Central Asia as it would allow countries to better reap the benefits of economic diversification, increased competition, a more efficient economic production structure and increased trade. For this to occur, an important precondition is the loosening of political constraints, which are still binding in Central Asia. In resource-rich countries such as Kazakhstan, Turkmenistan and Uzbekistan active government involvement and control remains particularly pervasive in the natural resources sector. In general, it has proven difficult to develop strong constituencies for institutional reform in resource-dependent countries. As long as these conditions persist there will be only limited progress in opening up markets, allowing private entrepreneurship to develop and reducing state-ownership. This will keep FDI at low levels compared with the rest of the transition region.
The transition outlook for this region remains clouded by political uncertainties and a general aversion to rapid market reform, especially during times of high commodity prices. Political systems in Central Asia have not yet developed mature institutions of interest intermediation and accountability, suggesting that incumbent governments and conservative policies are likely to remain in place despite whatever pressures for change may arise. These pressures have been muted during times of relative economic plenty. With commodity prices stabilising at a reasonable level, major institutional reforms in the resource rich countries appear unlikely. The 2006 Life in Transition Survey showed robust support for a “strong” state and government intervention amongst people in Central Asia (with the notable exception of Mongolia). Even in cases where there has been leadership turnover, as in Kyrgyz Republic and Turkmenistan, the appetite for reform has remained subdued.

4.1.3.1 Corporate sector

Transition challenges and opportunities
Transition challenges in the corporate sector of Central Asian economies continue to be significant. In particular, large challenges are still found across all countries in general industry where both market structure and market-supporting institutions need substantial further improvement. However, large challenges are also found in the agribusiness, ICT, and property sectors of Tajikistan, Turkmenistan and Uzbekistan.

The remaining transition challenges in the *manufacturing and services* sectors continue to be rated as large, with no change since the last assessment was made. State interference in the industrial sector continues to be high not only in Tajikistan, Turkmenistan and Uzbekistan, but also increasingly in Kazakhstan. The economies of Kazakhstan, Mongolia and Turkmenistan continue to be overly reliant on the natural resource sectors and economic diversification has not progressed in recent years. Although market distortions are limited in the Kyrgyz Republic and Mongolia, all countries in the region need to improve efficiency and productivity. Across the region further efforts are needed to enable successful restructuring and allow for effective competition. Corporate governance standards and business conduct are much lower than elsewhere in EBRD's countries of operations. The reduction of barriers for the entry of new enterprises remains a significant challenge.

The *agribusiness* sector is most developed in Kazakhstan, the Kyrgyz Republic and Mongolia, although even here quality standards and control are inadequate, techniques poor, competition and restructuring remains slow, the necessary transport infrastructure is often lacking and modern retail is still underdeveloped. State interference in the sector remains high in Tajikistan, Turkmenistan and Uzbekistan. Across the region, finance is lacking and only Kazakhstan has a functioning warehouse receipt programme in place.

The *property* sectors are still at an early stage of development throughout the region. In many cases property rights remain unclear and an adequate legal framework and conducive business environment for real estate development is still lacking. Across many parts of the region there is substantial unfulfilled demand for all types of property as well as for quality tourism infrastructure. Kazakhstan is the exception, since it has seen a real estate boom in recent years, although this has come to an abrupt halt due to the global crisis. Kazakhstan still has a substantial long-term growth potential for commercial property and adequate tourism assets, if further improvements are made to the institutional framework.

There are significant remaining challenges in the *telecoms* sectors of all Central Asian countries. Fixed, mobile and internet penetration rates are the lowest among EBRD's countries of operations. Most countries still need to liberalise the telecommunications market. Opaque regulation, the lack of liberalisation and the dominance of the state-owned incumbent hamper competition and lead to the absence of commercial incentives. Regulatory functions remain in state control or under strong political influence, leading to significant market distortions.

Bank activity

In *manufacturing and services*, the Bank will be engaged in the diversification of the economy in Kazakhstan by focusing on higher value-added projects, and by selectively supporting expected industry consolidation as a result of continued liquidity constraints. Support for FDI into export-oriented joint ventures will continue to be an area of focus. In other Central Asian countries ETC products will remain the main vehicle to support local manufacturing enterprises in their efforts to improve their business standards, transparency and competitiveness. Where possible, the Bank will support FDI investments into local enterprises.

In *agribusiness*, the Bank will support bankable private sector projects that address inefficiencies and low productivity in primary agriculture, particularly where up-to-date farming techniques and machinery can be introduced. The Bank will also target food distribution (including retail) and work with sponsors who are able to address global food security by increasing agricultural output and exports through productivity gains. The Bank will also promote high standards of corporate governance, integrity and transparency of ownership and support private enterprise and FDI investments and cooperation in Central Asia. In particular the Bank will promote the development of the local private sector of Kyrgyzstan, Turkmenistan and Tajikistan through standard financing and rural micro-credit programmes, supported by technical cooperation funds. The Bank will also seek to introduce financing schemes that expand farmers' and primary food processors' access to credit through systemic solutions such as grain warehouse receipts, legal reform on collateralization of agricultural land and bills of exchange of rural products (CPRs). Other forms of pre-harvest financing are also under consideration.

In the *property and tourism* sector, the Bank will support the entry of retail developers into the market by providing long-term debt and equity funding, and the development of regional logistics, retail, office, mixed-use and hotel facilities. The Bank will selectively seek opportunities to engage in policy dialogue with the real estate community, including investors, developers and authorities, to identify shortcomings and to contribute to the strengthening of the institutional environment for property development. It will also work with small/local sponsors under the DIF / DLF and MCFF mechanisms.

At the end of 2009, the government leaders of this region jointly and publicly recommitted themselves to the guiding principles from the World Summit on the Information Society (WSIS) to maximise the social, economic and environmental benefits of the Information Society. In the *telecoms* sector, the Bank intends to work with state-owned telecom operators and ministries to continue to offer pre-privatisation financing and restructuring support to fixed line operators and investing in regional network backbone projects (i.e. trans-Eurasian information superhighway). Financing broadband technology and the introduction of service businesses with SMEs via MCFF/DIF programmes remains an important objective. Effective policy dialogue in the region will not only focus on regulatory enhancements but also support building ICT institutional capacity programmes in partnership with the public and private sectors.

4.1.3.2 Financial sector

Transition challenges and opportunities

In Central Asia, Kazakhstan was the first transition country to be directly impacted by the crisis in the international financial markets in 2007. After years of rapid growth in bank lending, fuelled by foreign borrowing, credit growth came to an abrupt halt. The state has significantly increased its involvement in the *banking* system, not least through taking minority and majority stakes in several systemic banks. The crisis has exposed a number of underlying and deeper vulnerabilities of the banking system. In particular, the crisis has demonstrated that the excessive external wholesale funding of several Kazakh banks is not a sustainable business model and has shown that Kazakh banks have only to a limited extent been able to successfully intermediate their (ample) foreign funding into a diversified portfolio of profitable domestic projects. Risk management and corporate governance of Kazakh banks needs further strengthening as does the financial supervisor.

Access to finance remains an impediment to *MSME* development in Kazakhstan, in particular in rural areas. The legislative framework for *insurance* almost fully meets the international standards, and there has been a rapid development of private pensions in recent years. The development of the Kazakh *securities* markets has progressed somewhat, but challenges remain. Securities legislation continues to show some serious weaknesses even though a long-awaited Anti-Money Laundering Law has recently been adopted. A *private equity* culture is only very slowly emerging, with one relatively well-run fund still present at the moment. The government intends to play an active role in the private equity and venture capital market as well.

The less integrated and advanced transition countries in the Central Asia region, in particular Uzbekistan and Turkmenistan, remain on the periphery of global financial markets and are unlikely to be impacted much by the coming retrenchment in financial integration. These countries show predominantly large transition gaps across all four FI sectors. *Banking* sectors are very shallow, with Turkmenistan showing the lowest ratio of credit to GDP in the transition region. State ownership and/or heavy government involvement and directed lending still characterise the sector in both Uzbekistan and Turkmenistan. Moreover, restrictions on and delays in the convertibility of foreign exchange continue to hinder banks' operations in Uzbekistan.

MSME lending takes on particular importance throughout Central Asia to fund private enterprises and may also play a role in smoothing consumption patterns in countries that have recently seen a sharp reduction in their remittances inflows (Kyrgyz Republic and Tajikistan). However, poor collateral laws and the absence of well-functioning information sharing arrangements (e.g. credit registries) significantly impede the development of this sector (with the possible exception of the Kyrgyz Republic). Commercial *private equity* is largely absent as a funding source within these countries. Recent and very limited interest by international private equity funds has disappeared. Challenging business environments, limited investment opportunities and uncertain exit opportunities all hinder the development of this sector.

Bank activity

A key component of the Bank's crisis response in this region has been provided by vital trade finance through the TFP, when the risk taking capacity in the market was dramatically cut as international banks, insurance underwriters and export credit agencies withdrew trade lines. As trade volume starts to increase during recovery, demand for TFP support will increase and the Bank will be in a strong position to meet that demand through its partners in the region.

It is also essential to restore financing to the real economy. *MSME* lending will be a priority area directed through a range of bank and non bank financial institutions for long term sustainable financing. Risk-sharing instruments such as the extended use of MCFF will be used to encourage banks reluctant to take risk to lend to medium sized companies.

In Kazakhstan, the Bank will explore opportunities to work with the government to re-privatise recently nationalised *banks*. The Bank will work with partners to address institutional vulnerabilities and to promote business practices that support long term sustainability.

Other countries in the region are at various stages of financial sector development. The Bank will continue to look for opportunities for equity investment in financial intermediaries. These investments would be supported by policy dialogue and TC for institution building. Improved corporate governance and risk management are key areas for institution building throughout the region.

The Bank will also provide the full array of debt instruments as circumstances permit. The Bank will work with the authorities to promote increased use of local currency financing with a focus on development of local capital markets, in particular in Kazakhstan. The Bank will investigate opportunities to promote and invest in effective local financial infrastructure – including in basic utilities such as payment systems, registries, transfer agents and the other elements that enable development of local financial markets.

The Bank will continue to play a leading role in building nascent *private equity* activities by supporting experienced fund managers willing to move into the region and coordinating efforts with the other IFIs.

The Bank will also build on its ongoing policy dialogue working with the authorities in the post crisis period to move transition forward in this sector.

4.1.3.3 Energy sector

Transition challenges and opportunities

In Central Asia transition gaps in the energy sector are large and there has been little or no progress in recent years. In the *power* sector, Kazakhstan is more advanced than other countries in the region where the sector has been unbundled and commercialised and there is some private sector participation in generation. However, institutional capacity and independence of the regulator is weak and there has been some backtracking in market structure recently, as the government decided to re-bundle generation assets into a state holding and new capacity continues to be planned on a centralised basis rather than through market mechanisms. Elsewhere in Central Asia, the assets are largely or fully state-owned, little or no unbundling has taken place and there has been only limited progress in commercialisation and introducing financial transparency. Regulators are not independent (except in Mongolia) and electricity tariffs need to be increased from extremely low levels to attract investment and reduce excessive consumption. Regional cooperation in water and electricity trade is also an important challenge.

Many economies in Central Asia are heavily resource-based and in general, the state still controls the *natural resource* sector. The prevalence of unreformed and non-transparent state companies is the main transition challenge in countries like Kazakhstan, Turkmenistan and Uzbekistan. In Mongolia, where large-scale private sector projects in the mining sector are under development, the fair and transparent allocation of risks and rewards between state and private investors remains a key challenge.

Bank activity

In p*ower and energy*, the Bank will advance the transformation of the power sector through implementation of the Sustainable Energy Action Plan (SEAP) – including energy imbalances, regulatory institutional development and adequate tariffs, targeting projects with significant positive impact on efficiency and reliability of supply through both debt and equity financing to private generators (including gas and "clean coal"). The Bank will be promoting the privatisation of state-owned generating companies and joint ventures with western strategic investors in greenfield IPPs. It will continue engagement with the Kazakh transmission company, KEGOC, as an existing client and as a key market and infrastructure entity. The Bank will also pursue renewable energy projects in wind and small hydro and continue to assist the Government in the development of a framework for RES to attract quality investors. It will support regional gas and power distribution companies in reduction of commercial and technical losses and improvements in efficiency.

In *natural resources,* the Bank will support competition by working with smaller private operators, pipelines, related ports and infrastructure, retail service and storage sector. In Mongolia, the Bank will continue to promote increased efficiency and EHS standards of the emerging natural resources private sector, especially in the mining and mining-related industries. In addition, it will support the development of large scale projects that attract FDI and reputable international partners.

4.1.3.4 Infrastructure sector

Transition opportunities

In *transport*, the only country where some reform has occurred in the road and railway sectors is Kazakhstan, but even here there are still significant remaining challenges. Elsewhere, core railways businesses are still operated by the same entity (state-owned), while the road sector is largely unreformed in all aspects (no or limited private sector participation, unreformed road sector financing, very rudimentary institutional framework). Mongolia is currently developing a PPP framework for railway networks and operations, which are necessary to facilitate minerals trade with China.

The picture is similar in *municipal and environmental infrastructure*. In some cases responsibility for these services has been transferred to the municipal level; however, most municipal utilities operate inefficiently and are not fully commercial. Improving both financial and operational performance is a key remaining challenge. A pre-condition for this is tariff reform, as water and district heating tariffs barely cover operating costs, and improved governance and regulatory oversight. Contractual arrangements also need to be made more transparent. Private sector participation remains low and concentrated in urban transport, where small minibus operators provide an alternative to the weak urban transport system.

Bank activity

In the *transport* sector of Kazakhstan, the restructuring of the railway sector is expected to offer a range of opportunities for the Bank to support modernisation and commercialisation of state-owned rail activities, particularly freight operations. Some private rail operators may also seek support to develop and expand their operations. Support is also expected to be provided to further the government's aim of developing key road sections on a PPP basis. Some opportunities may also emerge to support private sector development of port and airport infrastructure in Kazakhstan once sector strategies are defined by Samruk-Kazyna. For *MEI*, efforts will focus on supporting sector reform (to encourage municipal finance) and regulatory improvements (in particular long term tariffs) especially for the water and urban transport sectors. PPP models will also be explored with reform minded local authorities.

In other countries of Central Asia, opportunities will continue to be sought to fund transport infrastructure alongside concessional lenders such as ADB, IDA and JICA to meet IMF concessional funding requirements. Key areas where such support might be provided include the road sector in Kyrgyz Republic and possibly port infrastructure development in Turkmenistan. Support to the water sector will remain a priority through a series of investments including in small and medium size cities and associated with reform undertakings to develop governance and regulation mechanisms. Consolidation of smaller municipalities will ensure sustainability as well as enable funding within affordability constraints. Municipal infrastructure investments will continue to rely on extensive support from TC and capital grants mobilised on a bilateral or multilateral (e.g. EU Central Asia Investment Facility) basis.

4.1.3.5 Energy Efficiency and Climate Change

Transition challenges and opportunities

Huge challenges remain in Central Asia in developing a market structure and institutions for *sustainable energy*. Across the region, low energy tariffs as well as a weak legal and institutional framework for sustainable energy create an unfavourable investment climate for energy efficiency and renewables. Tariffs are still not costs reflective and do not include environmental costs. Therefore price signals do not provide incentives to use energy efficiently and to invest in RES projects. Remaining challenges include to: increase energy tariffs to provide incentives for an efficient use of energy, develop and implement secondary regulations and strengthen institutions, introduce economic incentives to support market penetration of renewable projects, and strengthen capacity for carbon finance projects. Kazakhstan and Uzbekistan rank among the most carbon intensive countries among all parties to the UN Framework Convention on Climate Change (UNFCCC).

Bank activity

This region is the most vulnerable of the Bank's region of operations in terms of climate change, and is likely to see the first operational approaches to adaptation, e.g. funded by the multilateral Climate Investment Funds in Tajikistan. Policy dialogue will focus on the deepening of work already underway in Kazakhstan through the SEAP with the objective of having an institutional framework that will allow Bank sustainable energy investments to proceed. Based on the experience in Kazakhstan, the Bank intends to engage additional countries more closely in policy dialogue, e.g. with a view to enable investment in raising energy efficiency in public buildings, which will then be followed by the development and implementation of dedicated investment facilities. SEFF implementation in the early phase of CRR4 will be affected by the impact of the financial crisis in the region. In the smaller countries of the region, the SEFF approach is expected to be the main market entry instrument for sustainable energy investment. The Bank will therefore, over the course of CRR4, aim to extend the reach of SEFFs into new areas such as buildings, and renewable energy. It will also aim to broaden the geographic reach, including Uzbekistan which is among the most carbon intensive countries in the world. The Bank will identify opportunities to engage with large energy users through existing frameworks to demonstrate the potential of industrial energy efficiency investments. The Bank will also be facilitating the channelling of concessional climate finance streams which are expected to emerge during CRR4.

4.1.4 Russia

The Russian economy has been adversely affected by the global crisis through a number of channels. Firstly, the economy was exposed to a sharp terms of trade shock as the price of Urals brand oil plummeted from the peak of USD 138 per barrel in July 2008 to an average of around USD 44 in the first four months of 2009 before recovering to USD 65-70 by June 2009, and prices of ore, metals and steel also fell steeply.

Second, in August 2008 Russia experienced significant outflows of capital and withdrawal of deposits from the banking system, in particular from medium-sized and regional banks, prompting the Central Bank to inject liquidity on a large scale through uncollateralised loans to the banks and to permit gradual rouble depreciation. The rouble has since appreciated but remains about 18 % below the July 2008 peak against the dollar-euro basket. The stock market lost around three quarters of its capitalisation before bouncing back strongly. A few sizable banks on the brink of failure were swiftly nationalised through takeovers by state-owned entities. State-owned banks have experienced far faster asset growth during the crisis than private banks. Availability of trade finance and MSME credit has been sharply reduced, and syndications markets have been shut for all but a few top borrowers.

Third, weaker domestic and external demand and tight liquidity in the banking sector hit the real sector hard. In the first three quarters of 2009 output declined by 9.9 % year-on-year, with the steepest declines in the automotive and construction-related sectors. Large corporates have been forced to scale down, postpone or cancel large modernisation projects, including those with important energy efficiency components.

The crisis impact – measured in terms of contraction in industrial production, housing price decline and credit contraction – spread across the Russian regions gradually from the end of 2008 to the middle of 2009. Wealthier regions and those focusing on manufacturing were hit hardest while regions with better developed banking sectors and those less reliant on federal transfers were more resilient. Towards the end of 2009 the situation improved and positive growth is expected in 2010.

Russia had made good, if inconsistent, progress in transition in the years leading up to the crisis. According to the Assessment of Transition Challenges, Russia improved in either market structure or market institutions in 8 out of 13 sectors and was downgraded in only one. Progress in reforms and a larger and more active EBRD presence in Russia has created a virtuous cycle that should be continued in the CRR4 period to the fullest extent possible.

The severe impact of the crisis on Russia – in terms of output, employment, living standards and national mood – could be expected to influence the appetite for reforms. After the 1998 financial crisis Russia experienced sharp setbacks in transition in the short term, as well as political instability, followed by a pronounced market reform surge that was accompanied by a rebound in global commodity prices. In the current crisis, transition reversals have not been evident (with the possible exception of trade policy) and the political situation remains stable, partly due to the authorities' ability to cushion the impact of the crisis using its sizeable reserves position. As the country emerges from the crisis in the coming years, there is a prospect for further market-friendly reforms, but obstacles remain.

The current Russian administration has articulated clear support for modernising reforms that respect market discipline, including a new wave of privatisation, and the Russian government has several committed reformers in key positions of influence. The crisis has shown the vital importance of pressing ahead with measures to encourage diversification of the economy and moving more aggressively into high-growth, high-value added sectors in the knowledge economy. Doing so will require a more concerted effort to improve the quality of Russia's still weak institutions of economic governance. However, as oil prices have begun to return to their historically high levels, the incentives for reform may once again be dampened.

4.1.4.1 Corporate sector

Transition challenges and opportunities

Russia has made progress in reform in the corporate sectors in recent years, although significant challenges still remain to enable increased efficiency, effective competition and best practice in corporate governance and business standards. The state also continues to play a large – and in some areas growing – role in the economy, especially but not exclusively in strategic sectors. Competition in Russian markets is hindered by a high degree of industry concentration, substantial barriers to entry and insufficient controls over non-competitive behaviour by dominant players. Achieving improvements in these areas through further market-based restructuring in individual sectors presents a substantial challenge. Differences persist across regions within the Russian Federation.

In *manufacturing and services*, enterprise restructuring has advanced with many enterprises modernising their facilities, and some sectors have been consolidated through active mergers and acquisitions. However, increased state involvement in the sector has hampered improvements in efficiency and competition and the economy still needs to diversify away from the natural resource sector. There is scope for improvement in corporate governance standards, post-crisis restructuring and in exploiting technological innovation and the knowledge-based economy as an aid to diversification of the Russian economy.

In *agribusiness*, the modern retail format has made significant progress in large cities but has not yet advanced adequately in a number of regions. Many agribusiness sub-sectors remain fragmented with poor quality of products, inadequate hygienic controls and low production efficiency. There remains a substantial scope for restructuring and efficiency gains in farming, which could be achieved either directly or through competitive pressures and restructuring along the agribusiness value chain.

In *property and tourism*, the real estate sector has developed rapidly since 2005, and new instruments such as real estate funds and other investment vehicles have emerged. Regional cities pose the more notable challenges. However, the crisis has put many projects on hold and the legal framework and access to mortgage finance are insufficient to meet potential market demand.

In the *telecoms* sector, the Russian mobile and broadband markets are well developed in the major cities, but regional and rural penetration is low by comparison. Effective competition in the local fixed-line market has been hampered by the lack of an effective network access regulatory regime, with alternative operators consequently deploying alternative access network infrastructure.

Bank activity

In *manufacturing and services* the Bank will support diversification, increased value added manufacturing, higher efficiency and improved corporate governance standards. It will focus on sectors where most impact could be made by the Bank, including high tech industries, local forestry companies, automotive suppliers and industrial equipment, without excluding projects with high transition impact in other sub-sectors when appropriate. In cases where potential investments are in protected sectors the Bank will ensure the financial viability of investees without protection and, where possible, engage in policy dialogue to remove trade barriers. Taking account of the impact of the crisis, the Bank will continue to make a specific effort in the near term to address the short term needs of companies for reliable working capital, refinancing and operational restructuring, refocus on core assets and mergers and acquisitions. Over the recovery period the Bank will play its catalyst role in mobilising finance to support companies' technological modernisation, resource efficiency and productivity improvements. The Bank will seek to promote the application of the best available industry technology, business processes and innovative products to support the development of a knowledge-based economy. The Bank will work with the Russian Corporation for Nanotechnologies (Rusnano) to identify high tech innovative projects that could be considered for financing.

The Bank will promote the resumption of foreign direct investment in the sector. The Bank will actively seek equity investment opportunities in companies and use equity instruments - through its proactive investor role, including on investee company boards - to influence positively corporate governance standards. The Bank will actively support the efforts of the Russian Government to accelerate privatisation of stakes in state-owned companies, and will consider pre-privatisation investments in state companies that the government is committed to privatise, to support corporate governance improvements and restructuring to increase attractiveness of such companies for the private sector. The Bank will also consider investing along-side strategic investors in state companies at the time of privatisation or taking a minority equity stake during IPOs.

The Bank will enhance ordinary lending operations with energy efficiency lending to promote systemic change in the area of sustainable energy and to ensure the future competitiveness of clients. Through the instruments available (e.g., energy audits and energy benchmarking analysis), the Bank will promote dissemination of best available techniques and amplify its demonstration effects by building critical mass (see sections 4.1 and 4.5).

In *agribusiness*, the Bank will continue to support first and second tier foreign and local sponsors who are able through growth as well as linkages to suppliers and distributors to bring positive change in agricultural commodity trade flows, and remove bottlenecks in the food supply chain. The Bank will consider bankable projects that address inefficiencies and low productivity in primary agriculture, particularly where up-to-date farming techniques and machinery can be introduced and support sponsors able to address global food security by increasing agricultural output and exports through productivity gains. It will expand activities in upstream industries in close proximity to primary agriculture (such as services to farmers including seed multiplication, farm equipment and machinery manufacturing, storage and handling infrastructure). The Bank will develop an integrated approach to Russian retail, to include private sector support for modern food retail formats in regional locations, support for the development of infrastructure for suppliers and distributors alike and policy dialogue to address market entry obstacles, supplier/retailer relationships and competition in the market. It will also address continued inefficiencies in packaging and processing by supporting projects that introduce new technology and practice to the existing landscape. It will also introduce a range of financing schemes that expand farmers' and primary food processors' access to credit. It will also pursue policy dialogue in the grain sector (including the introduction of grain receipts together with the FAO and the Legal Transition Team).

In the *property and tourism* sector, the Bank will support the next stage expansion into the regional cities with a population of more than half a million focusing on delivering quality logistics/industrial parks/technoparks and mid-range hotels. It will also support economy class residential developments of reputable partners by focusing on selected demonstration projects in the housing sector, and selectively consider tourist facilities with strong sponsors in remote regions, such as in the south of the country. To implement this approach, the Bank will support the growth of investment vehicles, such as sector specific equity funds, pre- and post-IPO property companies and real estate developers that have the ability to transfer knowledge, promote standard international expertise, attract investors and introduce/upgrade energy efficiency standards in the local market.

Due to the sheer size of the country and stage of development, the communication investment needs that are required to effectively drive the diversification of the Russian economy are still massive. In the *telecoms* sector, expanding broadband access across the country remains a high priority. The Bank will be looking to finance the creation, expansion and/or upgrade of broadband operators (regardless of technology), support new business models through network sharing ventures (i.e. tower sharing, wholesale neutral network carriers, energy efficiency schemes, etc.) and building data centre capacity.

4.1.4.2 Financial sector

Transition challenges and opportunities

Although some improvements have been made in recent years, transition challenges in the financial sector in Russia remain significant. One of the key challenges will be to facilitate restructuring in the *banking* sector, in particular in medium-sized and regional banks. Risk management and liquidity management have not been developed adequately during the years of rapid loan book expansion in the run-up to the financial crisis. The immediate challenge is to facilitate a rebalancing of business models from growth towards quality, coupled with improvements in risk management and liquidity management practices. Although a wide range of banks and other institutions offer *MSME* finance, demand is far from being met and this segment of the market is still underdeveloped. The legal and regulatory framework is relatively weak, with credit registry and private credit information bureaus at an early stage of development and collateral and bankruptcy legislation unsupportive of MSME lending.

One of the main lessons from the global financial crisis is the importance of developing *local capital markets*. This requires improvements in the legal and technical infrastructure, in particular with respect to financial derivatives and hybrid financial instruments, such as convertible debt. A particular challenge is to promote the use of rouble instruments as benchmarks, building the term funding capabilities that could adequately address the country's vast investment needs.

The underdevelopment and institutional shortcomings in the *non-bank financial sector*, evident for instance in the fragmentation of the insurance sector where tax optimisation schemes were only recently banned, highlights the shortcomings in developing a more fully articulated financial sector. A highly developed *private equity* industry, and the buoyant issuance in domestic equity and private bond markets up to mid-2008, underlines the potential of market-based finance as a source of finance. However, the development of domestic sources of long term risk-oriented institutional investors remains a central challenge. Development of an institutional investor base (including pension funds, insurance companies, and asset managers) that will become core players in the market is an important aspect of building up local capital markets.

Bank activity

The Bank's focus will continue to be on supporting financial institutions' recovery in the aftermath of the crisis. Activities will include balance sheet repair, re-capitalisation, the provision of capital supporting products and support for banking sector consolidation. The Bank will work with strong banks that deal effectively with the legacy of the financial crisis and are viable agents for banking sector consolidation. The Bank will also work with banks to improve corporate governance and risk management.

To re-start lending to the real economy, the Bank will focus on providing priority products that support MSMEs. The Bank will not only provide SME and MSE focused credit lines, but will support banks with technical assistance for loan work outs and corporate recovery. As economic recovery gathers pace, TFP will be well positioned to provide vital finance to support increasing trade activity. To expand the products and the range of institutions providing finance to SMEs, the leasing sector and other forms of financing will need to be strengthened as part of the drive to improve financing for the real economy.

The Bank will roll out energy efficiency credit lines to partner banks capable and willing to diversify their loan portfolios. It will also support retail lending and the provision of consumer lending, including mortgage lending, provided it is undertaken in a prudent manner and embracing best practice standards.

Sustainability and stability of financial systems requires the development of sufficiently robust local markets to channel savings and investments in an efficient manner and to support well functioning local currency markets. The Bank can play an ongoing role through policy dialogue, TC, investment and its own Treasury activities to stimulate and support long term development. Key areas for investment include institutions to encourage long term savings such as insurance and pension funds.

The syndicated loan market needs to be re-established and the Bank can play an important facilitating role to re-establish the availability of longer-term funding in both local and foreign currencies, in a more prudent and balanced way than in the past.

In the longer term, securitisation and other forms of capital market products in a more simplified and transparent form will return to the market. The Bank can play a catalytic role in re-introducing these important financing vehicles to the country. Support for the local private equity industry will continue and new initiatives, such as supporting a revised form of Regional Venture Funds, will be explored.

4.1.4.3 Energy sector

Transition challenges and opportunities

Significant challenges remain in the energy sector. The economy remains heavily dependent on oil and gas production, which is increasingly dominated by state-owned companies, and suffers from the legacy of a highly energy intensive industrial structure. Transport bottlenecks may limit the country's export capacity as new capacity is brought on stream. Low domestic gas and electricity prices are not yet fully cost-reflective and do not provide incentives to use energy efficiently and invest in renewable energy projects. Improvements in transparency, standards of corporate governance, and environmental and business conduct remain a priority and an important challenge in the energy resource sector.

Progress has been made in *power* sector reform in terms of unbundling, privatisation of most generation assets and the establishment of a market for power. The key transition challenges are the completion of market liberalisation, the introduction of the long-term capacity market, commercialisation and privatisation of distribution companies, and the adoption of RAB tariff system in transmission, distribution and possibly heat generation. Clear regulation of renewable energy has yet to be developed.

Bank activity

In *power and energy*, the major operational and financing challenges are related to the renewal of an ageing infrastructure, the need to embed the recent liberalisation process and support its spread, and the development of renewable energy resources. Accordingly, the Bank will consider investments in: (i) new generation capacity to renew existing ageing infrastructure. Where appropriate, this could be done in conjunction with gas flaring reduction projects through investment in generation capacity fuelled by associated gas; (ii) renewable energy; (iii) privatised companies, IPPs and new entrants to strengthen and deepen market liberalisation; (iv) transmission capacity to eliminate bottlenecks and consequently create a larger, more liquid market; and (v) distribution networks to promote energy efficiency and commercialisation.

In the *natural resources* sector, the Bank will promote infrastructure type projects, including pipelines serving both the domestic and export markets, along with gasification projects of various regions and gas utilisation projects. The Bank will continue to follow various potential infrastructure projects in different regions of Russia, including the Far East. The Bank will also consider investments which lift constraints associated with development of oil and gas production and transportation, address gas flaring, support small and medium size independent oil and gas and mining companies promoting private investments and ownership in the sector, and contribute to environmental improvements, energy efficiency, and safety issues of past practices and/or enhancement of future practices.

4.1.4.4 Infrastructure sector

Transition challenges and opportunities
While important progress has been made in the *municipal* sector over the past few years, including the introduction of competitive tendering requirements for concession awards, tariff adjustments have not been implemented across the entire country. The financing of PPPs for municipal services has been scarce, especially under crisis conditions, with innovative financing solutions required to channel capital and know-how to the sector.

The private sector has been playing an increasing role in *transport* services in Russia, accounting for a major part of port terminal expansion and rail fleet renewal. A level playing field in transport service provision will require a stronger regulatory framework, with cost-based non-discriminatory tariffs for track, traction, and airport use and transparent and even access to monopoly assets and services. Improvements in governance of state entities and their restructuring and commercialisation remain key challenges, including continued implementation of the reform agenda in the railway sector.

Bank activity
In the *municipal* sector the development of pilot PPP projects or privatisation schemes in the solid waste, urban transport or water sectors will serve as benchmarks for sustainable private sector involvement. The Bank will actively pursue energy efficiency investments and reform both on the supply side (heat generation or transmission) and demand side (metering and tariff reform to be based on consumption), with an increased focus on small and medium size municipalities or regional projects, and in cooperation with Russian institutions such as VEB. Energy efficiency in public buildings and housing will be explored through pilot projects. Environmental investments are a high priority where gaps exist, notably water supply (health and reliability), wastewater (collection and treatment) or solid waste (land filling and other waste management schemes).

As the economy starts to recover, investment in railcar and shipping fleets as well as port infrastructure will be stepped up, providing significant opportunities in the *transport* sector in Russia. Further reform of Russian Railways and the state-owned port entity, Rosmorport, will provide additional funding opportunities subject to remaining within single obligor limits. Successful closing of the first PPP structures in the airport sector (e.g. Pulkovo) and the road sector (e.g. Moscow- St Petersburg highway) are likely to set the standard and may be followed by a programme of PPP projects also requiring support. This may be extended to regional infrastructure, where this can be provided on a commercial basis.

4.1.4.5 Energy Efficiency and Climate Change

Transition challenges and opportunities

Energy efficiency and curbing energy demand is one of the key transition challenges in Russia cutting across all sectors. The Russian authorities have shown an increasing commitment to promoting energy efficiency and putting in place a supporting institutional framework. The primary legal foundations for energy efficiency are already in place (including targets for energy savings), but the secondary legislation and related institutions remain weak and hinder effective operation of the framework and incentive structure for sustainable energy. Artificially low domestic prices of gas and other energy inputs have resulted in insufficient attention to energy management issues.

Despite recent improvements, industrial production remains highly energy intensive, and sustained competitiveness of many sectors crucially depends on reductions in energy consumption. At the same time, facing much tighter liquidity constraints, many large corporates have recently curtailed or postponed large modernisation projects with important energy efficiency components. Furthermore, a large proportion of residential and many non-residential energy users do not pay utility bills according to metered consumption, budget entities are not allowed to retain budgetary funds saved through energy efficiency and the institutional framework in the housing sector does not provide sufficient guidance on energy related rights and responsibilities, all of which provide little economic incentive for energy savings. Many private sector solutions to reduce energy use, such as ESCO companies, are not available in the current context.

Bank activity

The key focus will be on taking advantage of the increasing priority of energy efficiency in the Russian government, by utilising this developing momentum to engage more closely in policy dialogue and to build a strong foundation for mitigation investment. This will be particularly important in the area of buildings energy efficiency. Policy dialogue will build on the SEAP between the Bank and the Russian government to pursue targeted policy dialogue opportunities with the aim to provide for a better regulatory and legal environment for sustainable energy investment. It will also engage with FIAC to ensure that the message about the need for and benefits of energy efficiency is brought into the Russian government from several angles. The Bank will develop its support to local banks under the SEFF launched in 2009 to ensure pipeline creation and awareness raising, and extend the reach of the SEFF by expanding both the sectoral and geographical scope. The Bank will also support the development of carbon markets in Russia and pursue the structuring of GIS based on a hard greening approach.

4.1.5 Central Europe

Several countries in the CEB region were amongst the worst hit by the global financial crisis. Deep output contractions in these countries were driven primarily by the sharp drop in exports to the more advanced EU countries, the collapse of domestic demand and by a reversal in capital flows to the region. Following the return to growth of the Eurozone in the third quarter of 2009 and a strong recovery in capital flows into the region towards the end of the year, most of the central European countries have shown tentative signs of recovery in the second half of 2009.

However, in the Baltics and Hungary, growth is expected to remain negative in 2010 despite a gradual bottoming out of the deep recession. While fiscal consolidation is progressing in these countries, a lot remains to be done and popular support for drastic measures may be waning. In the CEB region as a whole, unemployment is increasing rapidly. Non-performing loans have continued their rapid upward trend and credit remains largely constrained to both the corporate and household sectors.

The crisis has had significant effects on the Bank's assessment of transition challenges in the CEB countries, mainly in revealing the underlying weaknesses in quality and functioning of existing institutions, particularly in the financial sector. The transition progress made over the CRR3 period was somewhat offset by reversals in either market structure or market institutions and policies due to the crisis. For the eight CEB countries, a total of 33 downgrades were recorded in the 2009 Assessment of Transition Challenges for all sectors for either market structure or market institutions, the bulk of which were in financial institutions (banking and MSME sectors). The fact that some countries experienced such sharp economic contractions during the past year is an indication that these structural and institutional improvements were less robust than originally thought and convergence with EU-15 levels of economic development is still a long way off.

With seven out of eight countries in CEB already in the European Union and one – Croatia – fairly advanced in the accession process, the market reform anchor remains very strong. Further progress in transition, including making up some of the lost ground due to crisis-related setbacks, can be expected in the CRR4 period, but at a modest pace. Two factors in particular may constrain the pace and breadth of reforms:

- first, the distance from the transition frontier is moderate for these countries, and closing the remaining gaps will require proportionally greater effort than typically needed at earlier stages of reform;
- second, constituencies for reform internally in some countries may have been weakened by the impact of the crisis while anti-reform elements in society may have been strengthened. Unemployment rates have risen dramatically across the region. The middle class has been particularly affected through the impact of the crisis on the mortgage market – having borrowed in foreign currency, households are now facing much higher debt burdens in countries suffering sharp exchange rate depreciations.

The risks of a backlash against reforms and further transition reversals during the early recovery period is low but should not be ruled out completely, especially if unemployment continues to rise and there is a second wave of the crisis stemming from the difficulties and structural problems in the corporate sector and convulsions in the still vulnerable banking systems (non-performing loans are likely to climb further in all countries as they normally lag the business cycle). There has already been some evidence of heightened state intervention in the economy in some CEB countries, e.g. in the pension sectors of Croatia, Slovakia, and Poland.

4.1.5.1 Corporate sector

Transition challenges and opportunities

In the corporate sector remaining transition challenges have been generally rated as small according to the 2009 Assessment of Transition Challenges. Most countries have aligned their institutional frameworks with EU norms and remaining challenges relate to improving efficiency, productivity and competition. However, in several countries there are still challenges in terms of privatising and restructuring certain sectors, improving corporate governance standards in medium-sized corporates and enhancing a focus on innovation in the business culture.

In *manufacturing and services*, there are still issues related to the privatisation and restructuring of sensitive industries in some countries (such as shipbuilding and chemicals in Poland) and a continued high level of state involvement and/or ownership in others (e.g. Slovenia). In most CEB countries, enterprise registration, bankruptcy procedures, and resolution of commercial disputes continue to be complex and lengthy compared with standards of more advanced EU countries. Corporate governance standards generally continue to be less developed than in more mature markets as a consequence of the crisis.

In *agribusiness*, the remaining challenges relate to improvements in efficiency and hygiene standards of agro-processors and in the distribution/packaging sectors (ensuring the traceability of produce, the development of private labels, specialised wholesalers, distribution centres, etc) while lending to the agricultural sector remains low.

In *property and tourism*, the main challenge in the short-term is the liquidity shortage (in both debt and equity) for property development in all sub-segments resulting from the crisis. Another challenge is to promote market development in regional cities and to develop liquid secondary property markets through the emergence of different types of property businesses, including large-scale domestic and international institutional investors and equity funds.

Few significant challenges remain in the traditional *telecoms* sector. The main outstanding challenges relate to the development of intensive knowledge-based economies which requires improvements in the legal framework (e.g., intellectual property rights), education standards, and ICT infrastructure.

Bank activity

In *manufacturing and services*, the Bank will support the recovery process by financing foreign direct investments and local entrepreneurs, focusing on projects in less developed regions with higher unemployment and will also consider financing the remaining privatisation in the chemical and pharmaceutical sectors in Poland.

Across the region, financing for investment has become extremely constrained, particularly for small- and medium-sized corporates. There is a concomitant rise in demand for equity and structured debt in the corporate sector. The Bank will continue to support regional expansion to less advanced markets through cross border investments.

In *agribusiness*, the Bank will focus on supporting local agribusiness companies with cross-border expansion plans into countries of operations where transition is less advanced. It will also support processing and food logistic companies with investments that improve their competitiveness, with a special focus on hygiene standards, energy efficiency and environmental sustainability.

In the *property and tourism* sector, to support the recovery process, the Bank will selectively support, particularly in Croatia, the delivery of quality retail, logistics/industrial parks as well as selective tourism investments that offer strong backward linkages and economic benefits towards the local economy.

In the *telecoms* sector, the primary focus will be to utilise the region's well developed workforce and during the recovery period the Bank will encourage the use of communications technology to increase productivity in all sectors of the economy.

4.1.5.2 Financial sector

Transition challenges and opportunities

The CEB countries have some important remaining transition challenges in the four financial institutions sub-sectors. Transition gaps in the *banking sectors* were assessed as medium or small, with high levels of state ownership in Slovenia and severe stress in bank funding and asset quality in the three Baltic countries and Hungary. Weaknesses in bank funding models and lending standards – importantly the foreign currency denominated retail lending that is prevalent in the region – are more apparent now than before the financial crisis. As experienced during the crisis, with some notable exceptions, regulatory frameworks need to be further strengthened. Once credit growth picks up again regulators will need to keep better control over potentially excessive credit growth and over banks' foreign currency exposures, particularly to un-hedged borrowers. Moreover, the weaknesses of cross-border regulations, particularly the lack of crisis management and burden sharing arrangements between home and host country authorities, are a key challenge.

The region's financial sector currently is not in a position to finance effectively the real economy, especially *SMEs*. The lack of financing to the corporate sector is compounding the already severe effects the crisis is having on SME supplier chains and unemployment. Innovative companies still do not have access to necessary funding from the capital markets for productivity enhancing investments.

Given the disruptions in financing through bank credit there is renewed interest in the development of local money and *securities markets*. The development of domestic money and bond markets was clearly discouraged by the pervasive substitution of the euro in financial systems. Hungary and Poland have sizable domestic government bond markets, though until a clear timetable for euro entry exists more could be done to stimulate domestic currency instruments, including corporate bonds and covered bonds issued by banks. As a result of the crisis, domestic equity markets are similarly illiquid in all countries except Poland and Hungary, though integration with markets in neighbouring countries may offer greater scope for issuance of and trading in equity. In many countries there was a significant presence of *private equity* firms before the crisis, an important source of capital and managerial skills for those companies in an expansion or restructuring mode, or for those too small to access public equity markets. Venture capital, vital for start-ups and growth companies, remains underdeveloped.

Bank activity
The Bank will remain focused and engaged in responding to post crisis investment needs in the region. The Bank will continue its close collaboration with other IFIs to ensure that support is coordinated and each institution's competences are appropriately deployed to deliver effective response programmes. The Bank plans to continue to deliver comprehensive project packages to its strategic partners that are active in the region.

During the recovery process, the Bank will also participate in bank recapitalisation and balance sheet restructuring by providing capital or capital supporting products, possibly in the context of further consolidation in some countries. If the conditions allow, the Bank will also support the privatisation of the few remaining state-owned banks in the region (in Latvia and Slovenia).

Over the past 10 years, the Bank has provided a significant amount of SME financing to the region, mainly through the EU/EBRD SME facility. Although many banks graduated from this initiative, SME lending has faltered as a result of the crisis and the Bank will look for ways to re-ignite lending to the real economy, and especially to this sector that forms the foundation of many economies. There will be targeted lending through both banks and leasing companies to deliver this objective.

Another key area - subject to the availability of donor support - will be energy efficiency credit lines to improve competitiveness during the recovery process.

Local capital markets are an essential component for effective and sustainable lending. The Bank will seek to develop local currency lending and deepen local capital markets through policy dialogue, Treasury activities and its banking activities. The Bank will also consider investments in local financial infrastructure in order to support the recovery of a fully operational financial system.

The Bank can play an important facilitating role to re-establish the availability of longer-term funding in both local and foreign currencies through syndication, selected re-opening of structured finance transactions and risk sharing. Consideration will also be given to rolling out further the innovative swap products that were introduced during the crisis to assist banks with managing their currency risk.

The Bank will encourage local pension funds to invest into private equity funds and it will support funds focusing on turnaround situations, or enterprise restructuring to accelerate recovery in the region. The Bank will also continue to encourage fund managers to co-invest with the Bank through the Co-Investment Facility.

4.1.5.3 Energy sector

Transition challenges and opportunities

The key remaining challenges in the *power* and *natural resources* sectors in CEB countries are to increase the diversification of energy sources and suppliers to improve energy security, grant third party access to transmission networks and promote greater competition and free market entry in the downstream oil and gas and power supply sectors. The Croatian, Polish and Slovenian power sectors remain largely in state hands, although legal unbundling and liberalisation of the electricity market has taken place. In Poland, coal sector reform is an important outstanding transition goal.

Bank activity

In *power and energy*, the Bank will support projects enhancing energy competition, diversity and security. During the recovery process long term funding from commercial banks will not be available. Therefore, the Bank will support the replacement of ageing and polluting power generation assets, including replacement of capacity after Ignalina NPP's closure. It will also increase power generation from renewable energy sources to meet EU targets for sustainable energy, and support energy efficiency projects. The Bank will finance distribution and transmission projects to reduce bottlenecks for connection of new renewable energy generation and support regional electricity transmission interconnections, especially in the Baltic States and Poland. It will participate in future privatisations of power companies leading to a further transfer of ownership to the private sector.

In n*atural resources,* the Bank will support regional pipelines, gas storage facilities, and related infrastructure to address energy security issues and EU regulations.

4.1.5.4 Infrastructure sector

Transition challenges and opportunities

Within the infrastructure sector, the remaining transition challenges in this region are modest, with some exceptions. The process of EU accession and harmonisation of legislation and regulations with the *acquis communautaire* has been a key driver of reform for the EU member states over the past several years, leading to greater market conformity and stronger institutions. Croatia, the only non-EU member state in CEB, trails the transition progress of other countries in this region.

The remaining transition challenges in the *MEI* sector are to build capacity and enhance accountability (predominantly in smaller municipalities), improve corporate governance, establish multi-year incentive-based tariffs to stimulate investments and efficiency improvements, remove cross-subsidies between consumer groups and fine-tune service contracts to allow greater private sector participation in the sector.

Transition challenges are greater in the *transport* sector. Concessions policies and financing arrangements in the roads sector has improved, and construction, maintenance and other services are generally contracted out; however, they are not always in line with EU standards. Recently, PPP tenders in the road sector have been launched in Latvia, Poland and the Slovak Republic. Their successful implementation, in light of the difficult market conditions, is a key challenge ahead. Elsewhere, operating and policy functions have been separated but challenges remain in terms of infrastructure access and full commercialisation of the railways.

Bank activity
In the aftermath of the crisis, engagement in the *MEI* sector will be provided where required to help address funding gaps in cooperation with EU cohesion funds and other IFIs and in support of transition gaps in view of the EU driven evolving regulatory environment. In these markets MEI will also explore new products to support the development of local capital markets, including revenue bonds.

During the recovery period there will be demand for Bank financing for large PPP transactions in the *transport* sector (motorway PPPs in Slovakia and Poland) and some private sector rail activities are expected in Poland.

4.1.5.5 Energy Efficiency and Climate Change

Transition challenges and opportunities
There are still considerable transition challenges in *sustainable energy*, at the industrial, municipal and residential level. Compliance with EU and global targets on climate change is a challenge, due in large part to the legacy of inefficient industrial, housing and infrastructure capital stock. Energy tariffs do not fully reflect environmental costs and some cross-subsidies remain, although the EU Emissions Trading Scheme and compliance with EU environmental legislation are significant steps towards pricing environmental costs. Energy intensity although reduced, is still higher than the EU-15 and OECD averages.

The legal and institutional framework for sustainable energy has improved but outcomes are lagging behind and further institutional strengthening is needed. Project development and implementation of commercially viable renewable energy and energy efficiency investments, especially in housing, municipal infrastructure and SMEs, as well implementation of green investment schemes, are key challenges. The agricultural and agribusiness sectors contribute significantly to greenhouse gas emissions and environmental degradation, and are therefore areas of significant potential for energy efficiency, carbon emission reduction and environment-related investments. The property sector faces the challenge of introducing/upgrading energy efficiency standards and employing commercially viable technologies and practices in the built environment to achieve significant energy savings.

Bank activity
The key focus will be on assisting the region in moving towards EU targets for 2020, by investment and targeted policy dialogue, and the utilisation of applicable EU instruments within a disciplined incentive framework. Policy dialogue will pursue targeted policy advice to support achievement of EU targets. A key objective will be to increase the leverage of public funds by providing options for dissemination tied to Bank lending. This is particularly important in the case of residential and public buildings, where the

Bank will pursue new financing approaches and access to new EU facilities such as ELENA. In the early phase of CRR4, the Bank will engage with local banks acting as intermediaries on SEFFs to ensure that they are able to build up a new lending portfolio in sustainable energy. Later the Bank will introduce new instruments to encourage local banks to increase lending for sustainable energy. In terms of carbon markets development, the Bank will pursue the structuring of further GIS in the region based on a hard greening approach and monitor the implementation of the GIS in Poland. Municipal infrastructure investment is of particular importance, and the Bank will seek to establish city/region-based action plans which will provide a roadmap for sustainable energy investments to local authorities. It will also pursue increased use of renewables in city heating systems.

4.1.6 Turkey

Turkey has weathered the crisis relatively well, despite a sharp output contraction in 2009. It is estimated that real GDP fell by 5½ percent in 2009 largely as a result of a drop in industrial production, especially in the textile, automotive, and metals sectors. Nevertheless, a recovery seems underway. Quarterly growth has been positive during the second and third quarters of 2009 on the back of a rebound in manufacturing production and transport services.

The crisis initially triggered substantial outflows and a correction in the stock market, but has since been followed by a rapid rebound. After falls of almost 40 per cent and more than 30 percent in the stock market index and the lira respectively there has been some correction, helped by a rating upgrade by Fitch in December 2009 and by Moody's in January 2010. Following supervisory reforms after the 2001 crisis, the banking system proved resilient to the market turmoil, not least because of its essentially closed net foreign currency position.

Looking ahead, growth is likely to recover in the short-term but be constrained by structural weaknesses in the medium- to long-term. In 2010, growth is expected to rebound to 4¾ per cent, fuelled by capital inflows and a recovery in the eurozone. A ½ percentage point of GDP fiscal tightening is unlikely to significantly dampen growth. In the medium-term, however, a weak business environment, high unemployment and regional disparities as well as the large size of the informal sector will constrain growth.

Transition challenges remain in all sectors. The largest challenges are in enterprise and infrastructure reform, competition policy, and nonbank financial institutions. The business climate suffers from weak licensing arrangements and regulation as well as competition from the informal sector. In infrastructure, the main weaknesses are in the railways, roads and water systems. Structural reforms have stalled during the crisis. A new IMF programme, reportedly under discussion, could boost investor confidence and support the structural reform agenda. However, in the near term radical reforms are unlikely because of elections in 2011 although privatisation may make further progress despite weak economic conditions.

4.1.6.1 Corporate sector

Transition challenges and opportunities

Although privatisation in *manufacturing and services* has progressed in recent years, restructuring and improvements in corporate governance and business conduct remain significant challenges to raise the productivity and competitiveness of Turkish firms.

In *agribusiness*, the lack of proper irrigation, the relatively small and uneconomic size of individual family-owned farms and the undersupply of capital for employment of modern production inputs, techniques and machinery prevent the country from realising its full agricultural potential. Transition challenges vary across regions within such a large and unevenly developed country.

Despite rapid development in the *property* market in recent years, the legislative and regulatory environment needs upgrading and the development of real estate is hindered by a difficult and time consuming process of land acquisition and obtaining construction permits.

In the *telecoms* sector there is an administratively and financially independent regulator, but the framework remains weak and the decision-making process is not transparent. Turk Telekom dominates the wholesale broadband market due to the reach of its network and lack of competing infrastructure. The business sector accounts for around 60 % of internet subscriptions, whereas the low level of PC penetration in the residential sector remains an obstacle to mass-market growth.

Bank activity

Turkey is undergoing a period of significant growth in non-traditional industrial sectors (ie non automotive, non-textile) that is driven by enhanced competitiveness relative to western and central Europe and by enhanced access to and growth in regional markets.

In *agribusiness*, the Bank will support first and second tier foreign and local sponsors, who are able through growth as well as linkages to suppliers and distributors to bring positive change in agricultural commodity trade flows, and remove bottlenecks in the food supply chain. The Bank will consider selectively investments in the *property and tourism* sector.

While Turkey has not formally adopted the EU regulatory framework, it mainly adopts the definitions and principles from the EU telecom framework. Implementation of the principles will still take time, e.g. no licenses for providing local services have been issued- keeping Turk Telecom the monopoly provider. In the *telecoms* sector, the Bank will be looking to finance the expansion of broadband and mobile telephony penetration into the regions with private enterprises.

4.1.6.2 Financial sector

Transition challenges and opportunities

The Turkish financial sector remains relatively small in size and narrowly based. The *banking* sector is highly concentrated and state ownership accounts for about 30% of total assets. Domestic lending to the private sector is limited: private sector credit amounts only to about 32% of GDP, a level comparable to Georgia or Tajikistan. Institutional reforms, such as improved coverage of credit information services, better enforcement of bankruptcy laws as well as a geographically unified collateral registry would help to stimulate bank lending to *small businesses*. As in the banking sector, Turkey is aiming to align legislation and supervision in the *insurance* sector with the EU framework. Turkey is one of only three countries of operation with a small transition gap in *private equity and capital markets* (the other two being Poland and Hungary). The domestic equity market is among the deepest and most liquid of any country of operation, providing a viable source of capital funding to large enterprises in conducive market conditions. *Private equity* is still at an early stage and the foundation of the sector is more fragile and less developed than in most new EU member states.

Bank activity

EBRD's activities will be focused on key areas that are currently underserved in the market. The provision of MSME financing, including rural financing, through intermediaries will be a specific priority. The EBRD intends to further the outreach, particularly of MSE financing, to the regions and will therefore be engaged with clients with the capability and interest to expand their operations.

As part of the EBRD's Sustainable Energy Initiative, Turkey is a candidate country for developing targeted credit lines to local banks specifically dedicated for on-lending to energy efficiency projects. Donor support from the Clean Technology Fund and the EU is already pledged and negotiations with potential partners have started for providing lending for industrial, renewable and residential energy efficiency projects.

There may also be opportunities in the coming years for the Bank to bring its experience to bear in privatising state-owned financial institutions.

The Bank will consider a range of activities to develop the long-term funding capacity of local financial institutions, including through structured financing vehicles and syndications. Support will also be provided for the development of local capital markets and local providers of long term savings instruments and investment resources, such as insurance companies, pension funds and asset management vehicles.

The Bank will continue to focus on equity funds with an investment strategy targeting SMEs in order to provide much needed capital for growth. It will also support new emerging local equity fund management teams.

4.1.6.3 Energy sector

Transition challenges and opportunities

In the *power* sector, unbundling has been achieved but private sector participation is still very limited. Liberalisation and privatisation are proceeding slowly. The country has an exploitable potential in renewables. In the *natural resources* sector, Turkey is an important transit country for oil and gas supplies to Europe, with an extensive pipeline network that is operated by state-owned BOTAŞ. A key challenge ahead is to reduce BOTAŞ' market dominance.

Bank activity

In *power and energy*, the Bank will support the government's privatisation and energy sector reform programme through both direct investment and policy dialogue. Given the numerous power and natural gas sector entities expected to be privatised during the CRR4 period, there is significant opportunity to provide debt and equity financing, linked with technical cooperation. Additionally, renewable energy (primarily wind and hydro) will be a significant focus as the potential for renewable power generation is among the best in the region and the regulatory environment continues to mature.

In *natural resources,* the Bank will promote projects promoting security of supply and multiple transportation routes for various commodities with particular attention to environmental and energy efficiency factors.

4.1.6.4 Infrastructure sector

Transition challenges and opportunities

Key issues in the *MEI* sector include limited decentralisation, where even large metropolitan municipalities remain dependent on funding support from the central government (e.g. through Iller Bank), and some shortcomings in the legal framework, notably the lack of corporatisation of municipal services and a still largely untested concession regime. Sub sovereign borrowing therefore remains the exception rather than the norm and the dynamic private sector is restrained in its development by legal risks and limitations. In the *municipal* sector, access to services particularly in smaller municipalities is still a problem and the concessions legislation needs further improvement. In *transport*, potential PPP projects have been identified in railways and roads, but these have not yet been tendered, while tenders for concessions in ports have been proceeding, but with limited success thus far.

Bank activity

In *MEI*, the Bank will work with municipalities on a non-sovereign basis to support tariff reforms and institution building with a focus on most needed investments e.g. urban transport, wastewater or solid waste. It will also support private sector operators, both FDI and local, through equity and debt for projects in environmental infrastructure to demonstrate the viability of concession type arrangements and attract more private investment in the sector.

In *transport*, the privatisation of state-owned ports potentially offers a number of opportunities to develop port infrastructure. These will be a key test of the adequacy of the concession legislation and tender process followed by the government. As the market recovers, private sector participation in the development of port infrastructure can also be envisaged. Concessions for road development may provide additional opportunities as well as selected opportunities in other areas of the transport sector, such as airline servicing.

4.1.6.5 Energy Efficiency and Climate Change

Transition challenges and opportunities

In sustainable energy, basic institutions and policies for energy efficiency, renewables and climate change have been established, but further efforts are needed to encourage energy savings and achieve more effective energy efficiency project implementation. Energy tariffs adequately reflect costs and provide incentives for low cost efficiency measures, but still do not reflect environmental costs. The Turkish economy is relatively energy efficient (low energy intensity). The renewables framework provides support, including feed-in tariffs and mandatory off-take, to a variety of renewable energy technologies. The use of renewable resources (biomass, geothermal, solar) is fairly extensive. Turkey has recently ratified the Kyoto protocol. Remaining challenges are to achieve more effective energy efficiency project implementation and support institutional support and project deployment for climate change mitigation.

Bank activity

The key focus will be on assisting the country in implementing its low-carbon growth strategy. This will be supported by policy dialogue through increased co-operation and the signing of a SEAP, as well as targeted policy advice to support Bank investments. The Bank will combine SEFF operations with multilateral climate mitigation funding such as CTF to promote low-carbon transition. It will furthermore develop bank relationships for co-financing larger industrial energy efficiency and renewable energy projects, with technical support on audits and training, and explore new financing instruments in the financially intermediated sector, appropriate to a mature banking market such as Turkey. Once Turkey becomes eligible for carbon finance measures, the Bank will develop policy dialogue to ensure that the legal framework for carbon markets is supportive to investment. Industrial energy efficiency will be an important and the Bank will seek to identify pilot energy efficiency projects in energy intensive sectors using energy audit and energy management instruments. Having established a track record in this new market, the Bank will consider expanding its activity to smaller companies, supported with technical assistance and using stream-lined project mechanisms such as direct lending facilities. The power sector will require significant investment to support Turkey's economic growth. The Bank will seek to ensure that renewable energy accounts for a high share of new supply.

4.2 Project monitoring

Project monitoring addresses issues arising at an individual project level, in contrast to the concerns of broader portfolio management discussed above which affect the Bank's projects in aggregate. The objective of project monitoring is to assess whether the Bank's objectives in a project are being met, and where possible to undertake remedial action if they are not. Monitoring is focused not only on credit issues, but the full range of the Bank's objectives for a project including transition, environment, procurement, use of proceeds, integrity, and other issues. Effective monitoring requires:

- awareness of opportunities to advance the Bank's objectives;
- awareness of risks which may prevent the Bank's objectives for its projects from being met;
- close engagement with the client to assess project development in general, and in relation to these opportunities and risks in particular – this requires client meetings, site visits and a covenanted structure of regular reporting on relevant aspects of client and project development; and
- review of information received, and an assessment of action required if Bank intervention is needed to safeguard the project objectives (for instance through discussion/negotiation with clients or other entities affecting the Bank's project and its environment).

Effective monitoring therefore involves care in design of the project before signature to ensure that these factors are taken into account, together with diligent attention to project developments after signature while the project is developing and while the Bank's financing remains outstanding.

The impact of the recent crisis represents a challenging test for the Bank's approach to project monitoring, which is proving to be robust. The Bank's response to the challenge has been to increase the intensity of its engagement with its clients. This has involved increasing the frequency of client visits and discussions, and in some cases adapting the depth and frequency of formal reporting of selected early warning indicators. This reflects an approach where the full sharing of information and open discussion of problems is best to enable the Bank to respond constructively to the problems faced by clients due to events beyond their control. Evidence that the Bank's approach to monitoring has worked well (in conjunction with the prior approaches to client selection and project design) is that objective indicators of problems in the portfolio (e.g. non-performing loans and specific provisions) are significantly lower than for commercial banks operating in the region, that where problems have emerged they have not been ones which could have been prevented by more effective monitoring, and finally that the Bank has in many cases been able to structure additional facilities for clients to support their response to the crisis.

The Bank faces two types of challenge in relation to project monitoring during the CRR4 period:

- *Addressing the continuing effects of the crisis:* the impact of the crisis on client credit quality will continue to be felt in the initial part of the CRR4 period as delayed effects take time to work through. Significantly lagged effects can occur because a client's financial and operational reserves are gradually exhausted, because of chain reactions through third parties with an impact on client credit (banks, suppliers, customers) and because other creditors of the client may become less accommodating as time proceeds. Moreover, there is continuing risk that the focus on short term financial survival can distract attention from longer term transition and environmental objectives which are important both to the client's longer term health and to the Bank's objectives for the project. For all these reasons, the Bank needs to sustain an enhanced monitoring effort and a corresponding increased intensity of client engagement on these issues well after the initial impact of the crisis is evident.

- *Impact of strategic developments in the Bank's portfolio during the CRR4 period:* a number of trends which were evident during the CRR3 period and which required a strong focus on monitoring quality and an increase in resources for monitoring will continue during the CRR4 period. These include the continuing higher proportion of Bank projects in less sophisticated environments where the impact of external pressures and regulations to achieve the required operational standards are less certain in their effect, the higher proportion of clients with less experience of international standards, as well as an increase in the sheer number of projects in the Bank's portfolio.

The prime responsibility for meeting these project monitoring challenges lies with the Banking Department. All projects have Operation Leaders (OLs) responsible for monitoring the project and supervising, with particular tasks assigned to project team members. OLs and other staff involved review the formal reporting received from the client and visit the project and the client to get a direct hands-on understanding of what is happening and how it affects the Bank's objectives. Group or team Portfolio Managers supervise the monitoring activity and are involved in decisions where remedial action is needed and is practical in order to try to ensure that project objectives can be achieved. Portfolio Managers provide additional focus, complementing the experience which the Banking team and group Directors can bring to the task from the direct line management.

Staff in other departments than Banking including Credit, Procurement, Environment, OCE and OGC also have an important role in monitoring. The role of the Credit Portfolio Review Unit is described in the Credit Process Paper. Other departments identify the staff responsible for reviewing project monitoring information and reports within their area of responsibility. The monitoring process also benefits from the lessons learned and identified through independent reviews of the Bank's projects or its processes carried out by the Evaluation Department and (in relation to certain processes related to monitoring) by Internal Audit. Managing Directors in Banking are responsible for ensuring effective co-ordination among these Departments and Banking to achieve the Bank's objectives for their portfolio.

Monitoring will absorb increasing resources during the CRR4 period. In order to achieve a balanced approach, it will be important to ensure that the requirement for increased resources is mitigated to some degree by ensuring that monitoring work is well calibrated for the degree of risk and opportunity faced in different situations, and that the Bank's approach continues to reap efficiencies from the increase in the number of repeat projects with the same client. The practical consequences of the strong focus on monitoring will be determined and developed in the context of the annual budget reviews during the CRR4 period.

5. TECHNICAL ASSISTANCE AND CONCESSIONAL FUNDING

Grant and concessional resources from donors and from the EBRD Shareholder Special Fund play a vital role in enabling the EBRD to address the transition challenges in its countries of operations. Funding from bi-lateral donors, EBRD hosted multi-donor funds and external multi-lateral sources provides technical assistance and non-TC funding to support a range of specific operations, including project preparation, project implementation, institution building, development of management skills, regulatory development support and policy dialogue.

It is increasingly recognised, not only by the Bank but by the donor community and by other International Financial Institutions, that blending of policy driven investments with grant funded instruments in the form of technical assistance and other types of concessional finance is vital to breaking down barriers to investment and to achieving common objectives. At the same time the EBRD, by virtue of its mandate and business model, places a particular premium on such instruments as tools for market development. This means that the Bank has a special mission to deploy grant funded instruments in a targeted and focused manner, with an emphasis on sound implementation, demonstration and avoidance of market distortions. Recent monitoring analysis by the Office of the Chief Economist demonstrates the pivotal role played by donor funded TC and non-TC to the achievement of the Bank's transition objectives.

It is expected that during CRR4, the Bank's usage of grant funded instruments will substantially increase. This is driven in particular by the following:

- The economic crisis in the Bank's region, which is deeper than elsewhere in the world, requiring a continued robust response by the Bank. Recovery, when it happens, is expected to be fragile and protracted with a strong demand for support from the Bank over the medium term including increased demand for grant funded instruments.
- Strongly enhanced operational demands for TC.
- Focus on the ETC and Western Balkans regions resulting in an increasing volume of more smaller, complicated and riskier projects, which are TC intensive
- Expansion of the Bank's activities in climate change and energy efficiency. Due to the high prevalence of market failures in this sector and the urgency of the climate change challenge, operations can be particularly grant intensive.
- Possible selected use of an integrated approach to project design and implementation with an emphasis on policy dialogue, including through a significantly enhanced TC component.

Some of these factors were already at work during CRR3, leading to a 40% increase in annual TC commitments from €73 million in 2006 to €102 million in 2009. This upward trend in demand for technical assistance funds is projected to increase during CRR4 to an average annual projected commitment volume of technical assistance of up to €150 million. Non-TC (grant and concessional co-financing, guarantee and risk sharing instruments) is likely to expand significantly, with a focus on climate change and environment and driven largely by the operational demands of the Sustainable Energy Initiative.

At the same time, there have been important changes in the donor environment. Donor budgets are under pressure as a result of the global financial crisis with resources being refocused to the neediest regions, and there is a marked trend towards multi-donor funding. Therefore, it has become necessary for the Bank to sharpen its approach to grant funded instruments, based on the need to ensure that funding demands are met alongside taking account of donor priorities. The Bank is pursuing a three pillar strategy for CRR4 to ensure that technical assistance and co-financing objectives are met in the period ahead. The three pillars comprise: (i) quality, effectiveness and efficiency of management; (ii) enhanced donor partnerships; and (iii) a sustainable EBRD Shareholder Special Fund.

5.1 Quality, effectiveness and efficiency of management

The Bank treats donor resources with the same rigour and standards of fiduciary care as it does its own resources. In the context of CRR4, the Bank will seek to further enhance both the efficiency and the effectiveness of the delivery of grant funded instruments. In this respect, the Bank has been reviewing a number of issues relating to both the inflow and the use of donor funds. The increasing importance of streamlining the delivery of donor funded projects, both to maximise the effectiveness of the assistance and to ensure best value for money, has highlighted the need to address the issue of untied funds and of cost sharing with the beneficiaries of technical assistance. In addition, more generic questions on the purpose and management of TC funds have been raised which are relevant to the effective use of donor funding.

Implementation

The Bank's capacity to meet the need for increased delivery of grant funded instruments is dependent on the availability of resources both in terms of funds and in terms of staffing. The Bank's grant funded projects are planned, implemented and monitored by the bankers that design and implement its investment projects (with the exception of legal and regulatory stand-alone TCs and TAM/BAS advisory service TCs), ensuring that the goals of these instruments are fully in line with the needs of the investment project. The destination of TC funds is checked and controlled by a dedicated approval body (the TC Committee). Bankers are supported by dedicated TC staff or units working in Banking (e.g. FI TC Group) and as well as by specific units within the Bank (such as the Official Co-financing Unit, the Consultants Services Unit and the Finance department) in obtaining funding, procuring consultants, managing contractual relationships and disbursing appropriately as well as monitoring TC funded project portfolios.

Ultimately the ability to deliver well designed and implemented TC and co-financing projects depends on the time available to bankers to prepare and monitor these activities. In parallel, TC projects that are not directly linked with investments (such as policy dialogue or legal and regulatory reform) require dedicated staff to implement them. With increasingly demanding investment targets and a more ambitious policy dialogue/reform agenda, the need for matching staff resources will become even greater if the EBRD is to ensure quality of implementation of investment linked as well as stand-alone TCs. TC and co-financing related staff requirements will be a driver of the Bank's resource requirements during CRR4, for both support units and the banking department to manage and implement these projects.

The issue of client ownership of technical cooperation assignments, including through cost sharing, has been acknowledged as an important element for further analysis and development during CRR4. The principle of sharing the cost of TC has been present since the beginning of the TC funds programme and continues to be valid today. Nonetheless, the growth of the TC programme, developments in other IFIs and the concerns of donors, all necessitate a fresh look at this question.

Work is underway to address key implementation questions of effective design of instruments, resources to implement them, and client ownership including cost sharing.

Process and administration

Around 40% of the Bank's current technical cooperation funds (excluding the EBRD Shareholder Special Fund) are tied to some degree. While the Bank has benefited from these tied funds, which have often proved instrumental in implementing projects in difficult environments, it should be recognized that these impose an administrative burden on the Bank's Management and do not always lead to optimum procurement outcomes. EBRD experience indicates that procuring consultancy services using tied funds is a more complex, time-consuming and at times less successful process than using untied funds. Piecemeal tied funding availability can also lead to poor TC project design and splitting of the consultancy assignment resulting in inefficiencies. Bi-lateral arrangements on an untied basis are already well established and easy to implement.

It is recognised that the EBRD must meet the commitment made by its shareholders to the Paris Declaration and to follow the example of other MDBs on untying funds. Discussions at the Informal Consultative Meeting and in FOPC showed a general understanding of the tied/untied question and while a range of views was expressed the balance of opinion would appear to favour the following approach:

- Bilateral consultations between OCU and all donors will be held on the basis of a rigorous analysis of data to assess the relative performance of tied and untied funds and whether there is a level playing field for consultants of all nationalities in bidding for EBRD consultancy contracts;
- OCU and CSU, with relevant Banking staff, will step up information dissemination to donors and their consultancy community on bidding for EBRD contracts; and
- In principle, no new tied funds will be accepted by the Bank from January 2011. Consideration may be given for some donors to work within additional transitional arrangements. The stock of existing tied funds, including new contributions received in 2010, will be grandfathered.

At the same time the Bank will address other procedural and administrative bottlenecks, including the utilization of unused funds, approval arrangements with donors and IT systems for donor funds management.
Work is underway to address these process and administration questions, with a focus on the case for untying, and on the measures that must be taken to make this change an effective and efficient one, both for the Bank and for Donors.

Learning lessons

In consultations with Donors, the Bank is in the process of enhancing its impact assessment. This work aims at a more systematic capturing of the transition and performance related impact of EBRD TC at client level. It also assesses the broader impact of the Bank's operations, taking into consideration community wide affects, such as poverty reduction, gender equality and environmental improvements. Associated to this work is the need to improve reporting to donors. Work is also underway in these areas.

5.2 Enhanced donor partnerships

Bilateral donors continue to provide the bedrock of the Bank's donor support. Examples of bilateral donor cooperation include:

- The recently concluded Sida-EBRD Municipal Environment and Climate Programme Fund of €20 million, which will be instrumental in providing investment grants and TC for water/waste water projects in the European Neighbourhood region.
- Cooperation with Germany for the EBRD Sustainable Energy Initiative. Germany has provided substantial funds (about €6 million) for Energy Efficiency projects in Kazakhstan, Russian Federation and Ukraine.
- The Italian Government has recently provided further technical cooperation and investment co-financing funds for the EBRD-Italy Local Enterprise Facility, established in April 2006 to meet the growing needs of local enterprises not sufficiently supported by other financing sources. The current value of the Facility is €168 million for investments and €6 million for technical cooperation.

Overall, about 20 bilateral donors have active programmes with EBRD and they continue to be an integral part of EBRD technical assistance programme. The importance of bilateral donor relationships to the Bank lies not only in the sums which are provided but in the diversity of objectives which donors have, and therefore in the range of operations which can be supported. Bilateral donors also promote innovation in the Bank, by using grants as an incentive to develop business in new areas or in new ways. Finally, bilateral donors, who are very often also shareholders of the Bank, provide an important operational link between the Bank and its Governors. For all these reasons it is imperative that these relationships are maintained, even as the Bank recognises the fiscal pressure which many Donors are now under.

Donor funds are also channelled through *multi-donor funds* whereby the resources from contributors are pooled in a fund which is established for specific purposes. The Bank has been active in the creation and management of such funds, established according to the Bank's focus and priorities. The ETC Fund has currently pledged funding of €65.9 million by 14 donors. Since November 2004, it has approved projects in the region of €10-12 million a year, mostly for TC activities. The Western Balkans Fund has been transformed into the Western Balkans Investment Framework, a joint EBRD-led initiative with the EC, EIB and CEB. Since November 2006, it has approved projects in the region of €10 million per year. Other multi-donor funds include the Northern Dimension Environmental Partnership – 14 grant investments totalling €87.9 million since 2002; and the Energy Efficiency and Environment in Eastern Europe Partnership established by the Swedish EU Presidency. These funds are set to make a significant contribution to strategic funding requirements during CRR4.

Multilateral donor financing is on the increase. Features of such funds include: contributions from several donors; availability of funds to several IFIs, with an emphasis on IFI coordination and co-financing; complex and resource intensive governance and administration; and availability of large volumes of grant or concessional finance, often focused on non-TC. Given the volume of available funds, such funds, facilities and frameworks offer challenges and opportunities to the Bank. The challenge is to engage effectively and with adequate resources to what can be somewhat burdensome and resource intensive structures based on institutional models that differ from that of EBRD whilst maintaining at all times the integrity of the Bank's market oriented principles in the use of grants. The opportunities lie in the possibility to leverage the Bank's operations with donor resources and other IFIs. The significant grant and concessional funds available also offer the opportunity to develop new, market oriented instruments for transition that can drive the direction and development of EBRD business. Such cooperation can have a lasting strategic impact. Current multilateral donor financing initiatives in which the Bank is engaged include: EU Neighbourhood Investment Facility; EU Western Balkans Investment Framework; Climate Investment Funds; Global Environment Facility. There are two main drivers to the growth of these mechanisms: climate change and EU financing:

- There is a strong recognition that, in a post-Kyoto context, global availability of resources for aid will not be sufficient to finance the required climate change adaptation and mitigation investments, as well as poverty reduction measures. In order to cover these needs, a growing premium is being placed on high leverage between budgetary resources, MDB finance, and private sector finance.
- In the context of the EU's external policies, there is a specific focus on the part of the Commission on strengthening the linkages and the leverage between EC budget resources and the resources of European financial institutions to support EU policy objectives. This can be observed in the Neighborhood Investment Facility and the new Western Balkans Investment Framework.

In responding to the crisis, in cooperation with the EU and in tackling climate change, Donors are increasingly asking the Bank to work alongside other international financial institutions. This presents new opportunities, giving the Bank the potential to leverage impact and streamline project preparation. Such inter-IFI cooperation seems likely to continue as a greater feature of donor relations. The most important partner for the Bank

in this respect is the European Investment Bank who participates in many areas of EBRD operations.
An annual contribution by the above donors to EBRD technical assistance projects is foreseen in the region of €100 million. Substantial additional resources are likely to be made available specifically for non-TC investment (grant and concessional co-financing and other instruments), notably from the multilateral funds.

5.3 EBRD Shareholder Special Fund

The Shareholder Special Fund has demonstrated its utility during its first 18 months of operations, and has become a vital instrument of TC and non-TC funding for the Bank's operations. Fulfilling its role to complement the work of existing donors, it has enhanced donor funding in two of the Bank's priority regions: the Early Transition Countries and the Western Balkans with matched funding. It has also provided flexible and timely funding to support banking operations, most notably in the Bank's Response to the Global Economic Crisis and in priority areas like sustainable energy and environmental infrastructure. Equally importantly, the EBRD Shareholder Special Fund has introduced a strong element of funding predictability, which is highly valued from an operational perspective. Finally it works as a "bridge" funding mechanism, in circumstances where donors could not provide their formal approvals to projects within the time-frame of the operational needs. In these instances, the EBRD Shareholder Special Fund could provide funding to enable the project to proceed, and the funds could be recharged from Donors once formal approvals are provided. The fund is also able to fill gaps that exist between donor priorities and the Bank's objectives. All these are attributes that will be even more valuable to the implementation of the Bank's strategies in the CRR4 period.

Based on an assessment of projected demand the total amount of funding required on an annual basis during the CRR4 period for technical assistance alone is around €150 million while expected Donor contributions for technical assistance alone is estimated at about €100 million. To ensure that the funding requirements are met Management estimates that there would need to be an annual contribution of €50 million from the EBRD Shareholder Special Fund over the five year period to meet the Bank's TC requirement. As in the past, it may be appropriate for a small proportion of these resources to be used for non-TC, although the bulk of funding for non-TC is expected to come from Donors.

Table 5.1: Indicative EBRD Shareholder Special Fund funding in CRR4

	€ million
ETC Region *	16
Western Balkans Region *	9
Climate Change/Energy Efficiency/ Environment	20
Others	5
Total	50

* Majority of the proposed allocation serves for co-financing with respective multi-donor funds.

This expected annual demand for €50 million is an orientation which will be tested from year to year against the evolution of real demand trends and the existing supply of funding. For 2010 – 2011 this supply may include a reallocation of any unused resources from the first two Shareholder Special Fund Work Plans (it is anticipated that the resources of the first two Work Plans will have been utilised at the rate of €56 million per annum, leaving a surplus of €30 million). Actual demand will also be influenced by the operational level of activity defined in CRR4.

In respect of regional allocations and the TC/non-TC funding, the mandate set out in the first Governors' Resolution establishing the EBRD Shareholder Special Fund will continue to be honoured, ensuring that the splits between ODA / Non ODA (at least 80% ODA) and TC / non-TC (at least 2/3 TC) will continue to be applied during implementation of the annual Work Programmes throughout the CRR4 period. For the ETC and Western Balkans, the proposed allocation includes resources to be utilised for co-financing with the multi-donor funds though not exclusively and can be utilised for other operations in the respective regions. Moreover, it is proposed that at least €2 million of the allocation across all categories pursues specific gender objectives (in particular, for the implementation of the EBRD's Gender Action Plan across these five priorities). There may also be a need for an allocation such as for cross-regional projects, integrated approaches including policy dialogue, or to accommodate urgent and difficult projects without finance from other sources.

It is not proposed at this stage to include a specific allocation to TAM/BAS. Prior to consideration of whether to allocate resources from the EBRD Shareholder Special Fund to TAM/BAS, there will be a specific Board paper on Sustainability and Funding of the TAM/BAS Program.
Regarding ODA country funding allocations, the Bank will continue to actively seek OECD recognition of DAC status for the ODA funding by the EBRD Shareholder Special Fund. Consideration could be given to create two more distinct ODA/non-ODA windows within the EBRD Shareholder Special Fund so that it is easier to identify the ODA part.

In summary, the case for a sustainable and predictable Shareholder Special Fund can be made as follows:

- funding gap – estimated at €50 million per annum.
- Some priority initiatives and projects of the Bank cannot be pursued using donor resources alone: donor objectives are not always perfectly aligned with Bank objectives;
- Donor cooperation: capacity of the Shareholder Special Fund to match funds and to bridge finance projects, enabling greater mobilisation of donor resources and more efficient cooperation;
- secure business development: EBRD staff have greater incentives to innovate and develop projects when the Shareholder Special Fund provides a security of funding which donors are not always able to provide;
- flexibility and ability to respond to unexpected needs: the Shareholder Special Fund has shown to be an adaptable tool in responding to the financial and economic crisis;

- financial impact: technical assistance is essential in many investment projects to deliver operations that meet credit requirements and sound banking criteria. In other words, TC mitigates risk and generates profits for the Bank; and
- transition impact: clear link between TC and grant funded instruments and the Bank's core mission. In particular, the impact and quality of operations is guaranteed by investments in technical assistance.

Based on the performance of the EBRD Shareholder Special Fund as a key instrument to promote transition and its established role in the Bank's operational framework in the context of the CRR4, it is proposed that the instrument should be assured a sustainable future in the medium term. Given the expected funding required from the EBRD Shareholder Special Fund over the CRR4 period, an orientation should be given to an annual resource allocation of €50 million to the Fund.

During the first year of the Fund's operation in CRR4 an allocation of €20 million will be sufficient, subject to an estimated reallocation of €30 million from the first two Work Plans.

APPENDIX 1: CORPORATE GOVERNANCE, POLICY FRAMEWORK AND CONTROLS

A1.1 Governing structure and responsibilities

The Bank's governing constituent document is the Agreement Establishing the European Bank for Reconstruction and Development (the Agreement) which provides that the Bank will have a Board of Governors, a Board of Directors and a President.

A1.1.1 Board of Governors

All the powers of the Bank are vested in the Board of Governors. With the exception of certain reserved powers, the Board of Governors has delegated the exercise of its powers to the Board of Directors while retaining overall authority. Unless otherwise provided in the Agreement, all matters before the Board of Governors are decided by a majority of the voting power of the members voting. The Board of Governors meets at least once a year at the annual meeting.

A1.1.2 Board of Directors and Board Committees

A1.1.2.1 Board of Directors

Subject to the Board of Governors' overall authority, the Board of Directors is responsible for the direction of the Bank's general operations and exercises the powers expressly assigned to it by the Agreement and those powers delegated to it by the Board of Governors. In particular, the Board of Directors approves all new loan or investment operations and frameworks, and material changes thereto. All matters before the Board of Directors are decided by a majority of the voting power of the members voting, except for general policy decisions which are decided by a majority of not less than two-thirds of the total voting power of the members voting or as otherwise provided in the Agreement. The President chairs the meetings of the Board of Directors and has a deciding vote in case of an equal division.

A1.1.2.2 Board Committees

The Board of Directors is permitted to establish committees to facilitate its work to the extent authorised by the Board of Governors.

The Board of Directors has established three Board Committees to assist the work of the Board of Directors: the Audit Committee, the Budget and Administrative Affairs Committee ('BAAC') and the Financial and Operations Policies Committee ('FOPC'). The procedures and terms of reference for the Committees were reviewed and updated in October 2009. Each Committee is comprised of no more than eight members, each of whom is a Director, and has a Chair and a Vice Chair. Members are appointed by the Board of Directors on the recommendation of the President following completion an informal nomination process which is supervised by the Chair of the Board Steering Group, with the support of the Secretary General. Each Committee prepares an annual report, for consideration by the Board, which should include a review of the Committee's activities, key issues that have arisen and an assessment of the Committee's performance. Each year the Committee should, in cooperation with Bank management, also review the adequacy of its terms of reference, making recommendations for amendment, as may be appropriate.

Coordination of the work of the Committees is undertaken by the Board Steering Group on a monthly basis. The Board Steering Group is comprised of two Directors, the Chair and the Vice Chair, the Chairs and Vice Chairs of the three Committees, the Secretary General and the Deputy Secretary General. Meetings of the Board Steering Group are open to all Directors.

The Audit Committee's terms of reference include oversight of the integrity of the Bank's financial statements and its accounting, financial reporting and disclosure policies and practices, oversight of the soundness of the Bank's systems of internal control, including receiving and reviewing periodic reports from internal audit, oversight and evaluation of the functions of the Internal Audit Department, the Office of the Chief Compliance Officer, the Evaluation Department and Risk Management, oversight of the performance of the Bank's external auditors, and other matters relating to internal control. The terms of reference of the BAAC include reviewing general budgetary policy, oversight of the Bank's human resources policies and issues concerning personnel, governance and ethics, administrative and organisational matters and oversight of the EBRD Shareholder Special Fund and uses of donor funding. Those of the FOPC include reviewing and overseeing the Bank's financial policies and general policies relating to operations, including application of the Public Information Policy and the Independent Recourse Mechanism, monitoring the Bank's strategic portfolio management within the framework of the medium term strategy, and monitoring the Bank's treasury performance. Each Board Committee discusses and reaches agreement without a formal vote and reports to the Board of Directors.

A1.1.3 The President

The President is elected by the Board of Governors[16]. The President is the legal representative of the Bank and conducts the current business of the Bank under the direction of the Board of Directors. The President is chief of the staff.

A1.1.4 Executive Committee, Operations Committee and TC Review Committee

Executive Committee. The Executive Committee ('ExCom') is chaired by the President and is composed of members of the Bank's senior management. It considers all key aspects of strategy, performance and financial soundness of the Bank.

[16] The President's term of office is four years and the President is eligible for re-election.

Operations Committee. The Operations Committee ('OpsCom') is chaired by the First Vice President and is composed of members and observers from the Bank's senior management. OpsCom reviews all project proposals. It considers all key aspects of the Bank's operations in judging whether individual projects fit the Bank's mandate, policies, and strategies and attaches conditions to its approval as necessary to enhance the fit and improve project quality. Once a project has been approved by OpsCom, the President submits it with an endorsement for approval to the Board of Directors.

OpsCom also approves proposals for significant changes to a project after its approval has been given, the use of legal remedies, exercise by the Bank of certain rights or consents with major consequences for the nature of the exposure, exits from equity investments, work-out proposals, and the establishment of special provisions as recommended by the Risk Management Department. In addition, OpsCom reviews country risk ratings and associated issues of risk and exposure.

The Operations Manual is intended to guide staff in the procedures and policies related to the operation cycle. It provides comprehensive guidelines in the order of events in the operation cycle, procedures to be followed, approvals required, documents required, timetables for submission of documents to Committees and the Board of Directors and the policy framework that governs the operation cycle and the activities of the Bank. The Operations Manual is amended as new procedures and policies are issued.

*Technical Cooperation Review Committee***.** The Technical Cooperation Review Committee ('TC Com') approves proposals for technical cooperation to be financed by donor funds by delegation of authority from ExCom. It has representatives of the departments concerned with both TC quality processing, as well as mobilisation of funding. The terms of reference of TC Com were updated and amendments approved by ExCom on 13 May 2009, primarily to reflect organisational changes within the Bank. It should be noted that donor funding for non-TC operations, such as grant co-financing of goods, works and/or services, is approved by OpsCom and/or the Board, as may be required, as part of the financing plan for the particular project.

A1.2 Organisational responsibilities

A1.2.1 Line organisation

The Bank is organised into Vice Presidencies and Offices.

The Head of the Banking Department is the First Vice President. The Banking Department is composed of seven Business Groups headed by Managing Directors: four Sector Business Groups (Energy; Financial Institutions; Industry, Commerce and Agribusiness; and Infrastructure) and three Country Business Groups (Central and South Eastern Europe; Russia; and Turkey, Eastern Europe, Caucasus and Central Asia). The Banking Department also includes a Managing Director for Portfolio Monitoring, a Corporate Director responsible for planning and Energy Efficiency and Climate Change, and Directors responsible for Corporate Equity and for the Operations Committee Secretariat.

The Finance Vice Presidency is composed of six departments: Budget and Financial Policy; Controller's Department; Information Technology; Loan Syndications; Strategic and Corporate Planning (joint report to First Vice President, Banking); and Treasury.

The Risk Management, Human Resources and Nuclear Safety Vice Presidency is composed of five departments: Risk Management, including Corporate Recovery Unit (joint report to First Vice President, Banking); COSO and Operational Risk Management Unit (joint report to Vice President, Finance); Human Resources; Nuclear Safety; and Official Co-financing.

The Environment, Procurement and Administration Vice Presidency is composed of four departments: Environmental and Sustainability Department; Procurement Department; Consultancy and Corporate Procurement Department; and Administration.

The offices include: Office of the Secretary General; Office of the General Counsel; Office of the Chief Economist; Internal Audit; and Office of the Chief Compliance Officer.

The Evaluation Department reports directly to the Board of Directors.

A1.2.2 Headquarters and local presence

The principal office of the Bank is in London[17]. Following completion of a review of the Bank's options in 2002 (of whether to remain at its current headquarters or to move to another building) the Bank decided to remain at One Exchange Square with revised lease terms agreed with the landlord.

The Bank has established a network of Resident Offices. As anticipated in the CRR3 document, the Bank closed certain of its Resident Offices during the period. Upon the Graduation of the Czech Republic, the office in Prague was closed and regional representation, together with representation in Slovenia, is handled through the Bratislava office in Slovak Republic. Estonia, Latvia and Lithuania representation is handled by the Baltic Regional Office in Vilnius.

The strategic role of the Bank's Resident Office network is to increase the efficiency with which the Bank can deliver projects, improve their quality and transition impact, and to widen the range of potential projects from which the Bank can choose. In this way the Bank can serve the countries of operations better in their transition to a market economy. The Bank's long-standing focus on development of the RO network's role reflects the fact that the financing and monitoring of projects relies more strongly than many types of banking on effective management of both private and public client relationships to generate and implement business efficiently, and on sensitive assessment of risks related to the local environment.

[17] The Agreement Establishing the Bank, Article 33 (1).

The larger Resident Offices are headed by the relevant Country Team Director, and all Resident Offices are part of one of the three Country Business Groups.

A1.3 Human resources

The President is responsible for the organisation, appointment and dismissal of Bank officers and staff in accordance with the Staff Regulations adopted by the Board of Directors[18]. In appointing officers and staff, the President is required to pay due regard to recruitment on a wide geographical basis among members of the Bank, subject to the paramount importance of efficiency and technical competence of Bank staff.

The international character of the Bank is enshrined in the Agreement which provides that the President, Vice Presidents, officers and staff of the Bank, in the discharge of their offices, owe their duty entirely to the Bank and to no other authority. Each member of the Bank is required to respect the international character of this duty and to refrain from all attempts to influence any staff members in the discharge of their duties to the Bank.[19]

A1.4 The codes of conduct

On 22 May 2006, the Bank's Board of Governors approved two new Codes of Conduct pursuant to Resolution No. 101: the Code of Conduct for EBRD Personnel and Experts and the Code of Conduct for Officials of the Board of Directors of the EBRD. The two codes replaced the previous unitary code, which, in conjunction with its two implementing orders, had regulated the behaviour of officials and staff members of the Bank since 1991.

Each code represents and articulates clearly the values, duties and obligations, as well as the ethical standards that the Bank expects of its officials and staff. The new codes build upon the high standards set by the 1991 code yet reflect the changes and improvements that have occurred to the corporate governance landscape over the intervening years. Significantly, the two codes have been aligned with existing best practice in the other international financial institutions and they provide guidance on avoiding and handling conflicts of interest. Moreover, each code establishes a transparent mechanism for examining requests for derogations, regulates the manner in which private financial affairs can be conducted and provides for an enhanced level of financial disclosure.

The codes incorporate a robust enforcement mechanism, together with detailed procedures for investigating alleged transgressions of the rules of the codes by members of the Board of Directors, the President and Vice Presidents.

A1.5 Policy and strategy framework

This section sets out the overall policy and strategy framework which establishes the Bank's approach to delivering its mandate. It describes the structure under five main

[18] The Agreement Establishing the Bank, Article 30 (5).
[19] The Agreement Establishing the Bank, Article 32.

headings: (i) mandated policies and strategies; (ii) sector strategies; (iii) financial policies; (iv) other policies; and (v) other operational strategies. In addition to the main policy and strategy papers a number of key related documents are also included. For convenience, the latest document reference number is provided in brackets after each item.

Mandated policies and strategies

In the fulfilment of its transition mandate the Bank is guided by four types of key strategy and policy documents which derive directly from the Agreement Establishing the Bank. These are:

- **Capital Resources Review.** In line with Article 5(3) of the Agreement Establishing the Bank, the Board of Governors shall, at intervals of not more than five years, review the capital stock of the Bank. The last review was completed in 2006 on the basis of the third Capital Resources Review which contained a review of strategic implementation, operational, financial and capital utilisation projections for the period 2006 to 2010.
- **Country strategies.** Country Strategies are a statutory requirement of the Agreement Establishing the Bank and a new Strategy is produced for each country of operations every two years. These Country Strategies perform a key function in defining operational priorities in each of the Bank's countries of operations. Moreover, in accordance with Article 11(2) (i) of the Agreement Establishing the Bank, which calls for an annual review of the Bank's country operations and lending strategy, updates to these Strategies are produced annually.
- **Procedures to implement the political aspects of the Bank's Mandate.** An important feature of the Agreement Establishing the EBRD relates to the political dimension of the Bank's mandate. The provisions concerning this are in Article 1, which sets out the Bank's purpose and the political aspects of its activities, and in Article 8, which deals with the use of the Bank's resources in this regard. The annual assessment of each country's compliance with Article 1 of the Agreement (in the Country Strategies) is underpinned in "Procedures to Implement the Political Aspects of the Mandate of the European Bank for Reconstruction and Development".
- **Environmental and Social Policy.** The Environmental and Social Policy details the commitments of the Bank as directed by its Agreement to "promote in the full range of its activities environmentally sound and sustainable development" (Article 2(1)(vii)). In line with the core commitment to promote environmentally sound and sustainable development, the Policy incorporates, not only ecological aspects, but also worker protection issues, as well as community issues, such as cultural property, involuntary resettlement, and impacts on indigenous peoples.

Sector strategies

The Bank has developed strategies (formerly called policies) to guide its activities in key sectors in which it operates. These strategies provide a broad operational framework for the various sector teams of the Bank. Current sector strategies include:

- Agribusiness Sector Strategy[20]
- Energy Operations Strategy
- Financial Sector Operations Strategy[21]
- Micro, Small and Medium-Sized Enterprises Strategy
- Municipal and Environmental Infrastructure Operations Strategy
- Natural Resources Operations Strategy
- Property Sector Strategy [22]
- Shipping Operations Strategy
- Telecommunications, Informatics and Media Operations Policy
- Regional: Trade Facilitation Strategy
- Transport Operations Policy 2005-2008

Financial policies

The Bank's financial policies and risk management provide guidelines for both Banking and Treasury management. Policies address capital, net income and reserves, liquid asset management, credit risk and portfolio management, portfolio risk management and investment policy, asset structure and pricing policy, liquidity policy, treasury authority and guidelines, borrowing and swap policies. The policies cover risks associated with the Bank's activities including credit risks, equity investments, guarantees and underwriting, market risks and counterparty risks.

The following are the current financial policies and related documents:

- Banking Credit Process Review
- Economic Capital Policy
- Financial Policies Compendium
- Gearing Ratio Interpretation Review
- 2009 Liquidity Policy Review
- Operational Risk Management Policy
- Portfolio Ratio Policy: Individual Countries of Operations
- Portfolio Risk Management and Investment Policies
- Policy Note on Portfolio Limits Review
- Principles of Planning and Budgeting
- 2009 Provisioning, Impairment and Loan Loss Reserve Policy Review
- Prudential Ratios Policy
- 2008 Reallocation of Net Income
- Sovereign Pricing Policy Review
- Strategic Operations Framework
- Treasury and Treasury Risk Management Authority

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20 This document is currently at Board Committee review stage.
21 An extended outline of the Financial Sector Strategy has been delivered at the FOPC.
22 The Property Sector Strategy is currently at Board Committee review stage.

Other policies

Various additional policies guide the Bank's approach to key dimensions of the Bank's activities both operationally and in its public responsibilities as an International Financial Institution.

These include:

- EBRD Financing of Private Parties to Concessions [23]
- Corporate Procurement Policy
- Enforcement Policy and Procedures
- Evaluation Function at the EBRD
- Independent Recourse Mechanism
- Project Complaint Mechanism
- Information Security Framework
- Integrity Risks Policy
- IT Security Policy
- IT Security Policy Review
- Material Changes Policy
- Procurement Policies and Rules
- Public Information Policy Review
- Work Out Procedures

Other operational strategies

The EBRD's activities are guided by certain key documents which chart the strategic direction of the Bank through retrospective examination and forward-looking analysis of the portfolio and operations, in addition to the individual sector and product strategies identified above. The main documents include:

- A policy on Graduation of EBRD Operations
- 2008 Strategic Portfolio Review
- Technical Cooperation Policy Review
- Use and Management of Donor Grants in EBRD Operations and Projects

A1.6 Administrative and capital expenditure

A1.6.1 Budgetary policies

The Bank is committed to tight budgetary discipline within a clearly defined framework of budgetary policies. The Bank's institutional objectives have been pursued within an overall manageable growth strategy, which balances planned increases in annual business and portfolio development with the need to manage the growth in operating costs.

[23] Concessions Policy currently under review.

The Bank's Principles of Planning and Budgeting reflect a number of features to ensure the transparency and efficiency of the planning and budgeting process and to achieve a rational allocation of resources. These include:

- specific annual business plan objectives linked to the Bank's strategy and mandate by means of an EBRD scorecard;
- clear line manager responsibility with over 90 per cent of total budget costs being under the budgetary responsibility of cost centre managers;
- transparency of the Bank's cost structure in accordance with cost allocation categories (direct project, project related, corporate support and institutional and corporate governance);
- expense budget based on expenditure net of cost recovery from third parties;
- transparent controls over staff costs and an absolute ceiling on Bank funded regular and local staff on board;
- fungibility of expenditure within clear limits, to ensure flexibility in the execution of the budget;
- budget resources for unforeseen development that can be allocated during the year from centrally managed contingency funds; and
- a capital expenditure budget based on a multi-year programme.

The annual Budget process presents three separate items for the approval of the Board:

- the staff compensation and benefit proposals;
- the annual administrative expenditure budget; and
- the capital expenditure programme budget.

A1.6.2 Expenditure authorisation, checks and balances

Administrative expenses and authorisation. Expenses are controlled by segregation of duties, allocation of specific responsibilities to designated staff and appropriate authorisation of expenditure.

The Bank's administrative expenses have two main components: direct costs and centrally managed costs. The annual budget for direct costs is broken down between each of the Bank's departments or units. Within each of these, the budget may be further broken down between cost centres as appropriate to ensure a high degree of transparency and managerial accountability. Direct costs include certain costs that are allocated to units on a standard cost basis, for example, staff benefits, IT costs relating to PCs and occupancy costs. Centrally managed costs, such as the Annual Meeting, are managed by a single department on behalf of the Bank.

Flexibility within the administrative budget for direct and centrally managed costs is achieved by holding each cost centre manager responsible for the total direct expenditure budget allocated to the cost centre rather than for each individual cost item on a line by line basis in order to allow necessary trade-offs. However, such trade-offs are not permitted between direct costs and centrally managed costs nor between the administrative budget and the capital expenditure programme. Budgetary reallocations requiring new policies, or changes to the Bank's approved policies, are subject to approval by the Board of Directors.

Expenditure must be consistent with specific policies and guidelines such as the Bank's Travel and Expenses Policy and the Corporate Procurement Policy. In addition, a number of departments perform a corporate function obtaining supplies and services on behalf of departments and setting policies and procedures in these areas. For example, all outside legal counsel are engaged and managed by the Office of the General Counsel and all contracts for consultants are centrally issued by the Consultancy Services Unit.

Capital expenditure programme and authorisations. The Bank's capital expenditure programme provides the resources for a multi-year programme of investment in fixed assets and comprises three broad categories: headquarters, resident offices and information technology investments. The total capital expenditure programme is formally approved by the Board of Directors and any major shift in expenditure between categories (whether for external or internal reasons) is reported to the Board of Directors in the Quarterly Institutional Performance Report.

Management has established specific authorisation procedures for capital expenditure. After overall approval by the Board of Directors, of the capital expenditure programme budget, each project within the programme is subject to further review before management authorises the project to proceed.

A1.7 Procurement policies and procedures

The Bank has procurement policies and rules consistent with its objectives of appropriate use of funds and efficiency of operations.[24]

The Bank places no restriction upon the procurement of goods and services from any country (whether or not a member); restrictions on eligibility to tender are permitted only on the basis of capability to perform the contract or applicable international or local legal prohibitions. For goods and services procured under the Technical Cooperation Funds Programme, this is also the case, subject to specific agreements that may be reached with individual donors.

Specific procurement rules for public sector operations apply to all goods, works and services contracts financed in whole or in part by the Bank or through a financial intermediary. The Bank requires the use of international competitive tendering for public contracts, where appropriate, as a condition to financing and permits selective or single tendering in special cases only.

[24] Procurement Policies and Rules. The Bank supports the development of public procurement laws and practices within countries of operations that are consistent with the principles of the WTO/Government Procurement Agreement.

Private sector operations may follow other established commercial practices in addition to formal open tendering. However, contracts should be in the best financial interests of the client and negotiated at arm's length. The Bank also requires competitive tendering methods where it is advising a government or public entity in contracting with private operators for a public works concession, with the objective of financing the ultimately successful concessionaire.

With regard to consultant services the main objective is the quality of services provided. The procedures depend largely on the value of the services to be performed.

In addition, the Bank applies its procurement policies and rules to contracts cofinanced on a joint basis. However, Section 2.4 of the Procurement Polices and Rules permits derogation from this rule, in exceptional circumstances, where the Bank is cofinancing with another IFI or other development agency, provided that the Bank is satisfied the alternative rules are fair and transparent, and subject to the approval of the Board of Directors. For contracts cofinanced on a parallel basis, a cofinanciers' procurement procedures may be applied but the Bank satisfies itself that such procedures are not inconsistent with its policies.

A1.8 Reporting

The Bank has a comprehensive system of reporting its transition, operational and financial performance on a quarterly basis to the Board of Directors, and on a monthly basis to the Executive Committee and senior managers throughout the Bank. External reporting is through the annual Financial Report and Interim Financial Statements.

The Quarterly Institutional Performance Report (IPR) provides coverage of transition, operational and financial performance to the Board of Directors. The IPR assesses on a quarterly basis the Bank's performance against its scorecard objectives. Each year the second quarter IPR includes the results of a detailed review of transition, operational, financial and budgetary performance, and a full year estimate. Similarly the fourth quarter IPR provides a detailed assessment of actual results against agreed targets. The Quarterly Risk Report provides a regular update to the Board of Directors on risk issues.

Within management, comprehensive monthly information on both operational and financial performance is provided in the Monthly Management Reports. In addition, detailed operational and financial information in respect of Banking operations is provided to Banking management and each business groups and team. These comprise printed Banking Monthly Operations Reports (B-MOR) reports and on-line intranet (e-MOR) reports accessible directly by staff both in Headquarters and Resident Offices. These show specific portfolio and pipeline parameters, and operational and financial results at business segment and project level. On line report of portfolio transition parameters has also been introduced.

The Bank uses the SAP accounting and budgeting system for expense accounting to provide up-to-date on-line information to cost centre managers and budget officers on administrative expenses, expense commitments, capital expenditure and cost recovery.

A1.9 Internal controls and operational risk management

On 1 January 2005 the COSO and Operational Risk Management (C&ORM) Unit was formed to co-ordinate the annual certification process of internal controls over financial reporting and further develop operational risk management. The unit reports directly to the Vice President, Finance for the certification process, working on a day to day basis with the Controller. For operational risk management the unit reports directly to the Vice President, Risk Management, working on a day to day basis with the Director, Risk Management.

Certification of internal controls over financial reporting

During 2004 the Bank completed a project using internal and external resources to implement a process to be able to certify, in the annual Financial Report, as to the effectiveness of internal controls over external financial reporting, using the COSO internal control framework. This annual certification statement is signed by the President and Vice President, Finance and is subject to a review and an attestation by the Bank's external auditors. The first certification was made for the 2004 Financial Report and is now repeated annually. The assertion and external auditor's attestation were included in pages 70 and 71 of the Bank's 2008 Financial Report.

Key internal controls relevant to the Annual Financial Report are documented by the C&ORM Unit, tested by line management and signed off by Senior Management in each department. These include specific controls relating to business areas across the Banks and IT application controls for those applications key to financial reporting. In addition, the scope includes top level or pervasive controls which are important in deriving the tone of the control environment within which the business specific controls operate. The testing is reviewed by the C&ORM Unit before being audited by the external auditors. In addition, documentation also includes producing and maintaining process flows of the major product cycles and performing walkthroughs of these key processes. Documentation on the key financial risks faced, key controls and their testing have to be kept updated with systems, organisational and process changes incorporated. Controls included in this certification process are those over the material processes and products which comprise the Annual Financial Report and those relating to the associated notes and disclosures. In addition general controls over the governance of the organisation and pervasive IT controls as related to the above are also incorporated.

Operational risk

Operational risk management at the Bank is co-ordinated by the C&ORM Unit and provides the overall framework and coordination structure for operational risk management to support line managers who control and manage operational risk as part of their day to day activities. The C&ORM Unit formulates proposals for discussion and review by the Operational Risk Management Group (ORMG) who has oversight of the process and review and monitor the implementation of the operational risk management policies and techniques of the Bank.

The ORMG is a group drawn from the Bank's senior managers most likely to be dealing with operational risk issues and meets four times a year, or more frequently if necessary, to review the progress of operational risk management development and provides a forum for discussion and exchange of ideas.

A document detailing operational risk management policy was approved by the Board on 20 September 2005. This was accompanied by a document detailing procedures for reporting key risk indicators and running an annual self assessment exercise. In addition regular reporting on operational risk is included in the Quarterly Risk Report presented to the Executive Committee and the Board of Directors.

A1.10 Internal and external auditors

Internal auditors. The Bank has an independent Internal Audit department which reports directly to the President and has unrestricted rights of access to all levels of management, the Chair of the Audit Committee and the External Auditors, as well as to all Bank records and files. The department operates in accordance with the standards prescribed by the Institute of Internal Auditors. The main objective of the Internal Audit Department is to provide a continual, independent appraisal of all the main aspects of the Bank's activities, with particular emphasis on the key risk areas, in order to assist management in the effective discharge of its responsibilities and determine whether the Bank's risk management, control and governance processes are adequate and functioning.

The Internal Audit department's work programme is approved by the President and reviewed by the Audit Committee to ensure its adequacy and efficiency. Periodic reports are produced containing recommendations for improvements together with management's responses. Such recommendations may relate to adherence to operational policies, procedures, or improvements to the efficiency and effectiveness of Bank operations and administration. Copies of each of these reports are regularly reviewed by the Audit Committee which makes an annual appraisal report to the Board of Directors on the adequacy and effectiveness of the internal audit function.

In addition to the regular reporting functions, the Head of Internal Audit is required to report any unusual or exceptional circumstances to the President and to the Chair of the Audit Committee.

External auditors. The external auditors are appointed by the Board, on the recommendation of the President, for a four year term. The external auditors perform an annual audit to enable them to express an opinion on whether the financial statements present fairly the state of affairs and profit and loss of the Bank and have been presented in accordance with International Financial Reporting Standards. In addition, the external auditors review and offer their opinion on Management's assertion as to the effectiveness of internal controls over financial reporting. This opinion is given as a separate report to the audit opinion. At the conclusion of their annual audit, the external auditors prepare a management letter for the Board of Directors, which is reviewed in detail and discussed with the Audit Committee, setting out the auditors' views and management's responses on the effectiveness and efficiency of internal controls and other matters. The performance of the external auditors is subject to review on an annual basis by the Audit Committee. Every effort is made to implement the auditors' recommendations with a view to removing any perceived weaknesses in control.

A1.11 Office of the Chief Compliance Officer

The Bank has an independent Office of the Chief Compliance Officer ("OCCO"), which is headed by the Chief Compliance Officer ("CCO"). In order to enhance the independence of the CCO's function, the Bank has recently adopted an Integrity Policy and Terms of Reference for OCCO which specify that the CCO reports functionally and administratively to the President and has full and free access to the Chair of the Audit Committee. As required by the Terms of Reference of the Audit Committee, any decision to remove the CCO shall be taken by the President in accordance with guidance given by the Board of Directors.

The CCO is responsible for promoting good governance and ensuring that the highest standards of integrity are applied throughout all of the Bank's work in accordance with international best practices. The role of the CCO is broad and includes dealing with integrity due diligence issues, confidentiality, corporate governance, ethics, conflicts of interest, anti-money laundering, counter-terrorist financing and the prevention of fraudulent and corrupt practices, by, for example, providing guidance, advice, initiating training and developing and administering appropriate standards and procedures. Moreover, the CCO is the head of the office in which the Bank's Project Complaint Mechanism (PCM) is located; and he/she is also responsible for investigating fraud, corruption and misconduct; and training and advising, as necessary, those nominee directors who are appointed to companies in which the Bank holds an equity interest.

The Bank established the PCM to enhance its accountability by assessing and reviewing complaints about Bank-financed projects. The mechanism gives organisations, or individuals located in an area affected by a Bank-financed project or who have an economic interest in that area, a means of raising complaints or grievances with the Bank, and have them reviewed by the Project Complaint and independent experts. The PCM aims to strengthen the Bank's corporate responsibility and to increase the transparency of its decisions in relation to its project operations. The PCM has two functions: a 'compliance review function', which is intended to assess whether banking operations comply with Bank policies, specifically its Environmental and Social Policy and project-specific provisions of the Public Information Policy; and a 'problem-solving function', which is designed to restore dialogue between the parties, where possible, to try to resolve the underlying issues giving rise to the complaint or grievance. A problem-solving initiative might include independent fact-finding, mediation, conciliation, dialogue facilitation, investigation or reporting. If eligible, a complaint may be processed for a compliance review or problem-solving initiative, or both or neither.

A1.12 Prevention of fraud and corrupt practices

The responsibility for preventing and investigating fraud and corruption within the Bank and its procurement activities lies predominantly with the OCCO. The Bank, over a number of years, has adopted a multitrack approach to combating fraud and corruption: prevention is targeted by varying means, including the imposition of systemic integrity due diligence procedures throughout the entire loan cycle, coupled with stringent internal and external audit obligations. These procedures allow the Bank to implement an enhanced "know your customer" risk-based approach, which acts to mitigate the risk of fraudulent or corrupt practices. Moreover, the Bank has implemented mandatory ethics training for all its staff members as well as in-depth integrity and anti-money laundering training for all project-facing staff. Detection of fraud and corruption is achieved by, for example, the imposition of a mandatory duty on staff members to report suspected misconduct, which includes dishonest practices, such as fraud and corruption, to the CCO for investigation. Additionally, the Bank maintains a 24 hour hot-line that admits anonymous complaints. Allegations of fraud and corruption can also be sent electronically to the OCCO at its compliance inbox address. Investigations of allegations of fraud and corruption on the part of staff members are conducted by the CCO under the aegis of the Bank's Procedures for Reporting and Investigating Suspected Misconduct ("the PRISM").

In addition to these preventive measures, the Bank's Enforcement Policy and Procedures (EPPs) entered into force in March 2009 following the establishment of the Enforcement Committee which is responsible for the determination as to whether an allegation of fraud, corruption, collusion or coercion has been substantiated. The EPPs apply across all the activities and projects financed from the Bank's ordinary capital resources, Special Funds resources (that is, funds from donors that the Bank then uses for investment and technical assistance activities), or from cooperation funds administered by the Bank. The EPPs set out how the Bank will process allegations of fraud, corruption, collusion or coercion (collectively referred to as "prohibitive practices") and incorporates the remedies previously afforded the Bank under its Procurement Policies and Rules, including cancellation of financing, and/or debarment. The prohibited practice need not have occurred in connection with a procurement exercise but may have occurred during the execution of the Bank project, such as by misappropriation of funds or bribery of officials. The policy and procedures also enable the Bank to take action against individuals or entities that have been found to have engaged in prohibited practices by either a judicial process in a member of the Bank or a finding by the enforcement (or similar) mechanism of another international organisation (a third-party finding). The EPPs also provide for measures that help the relevant entity address deficiencies in its control or compliance function that may have contributed to a prohibited practice and/or to reduce the Bank's risks in carrying out the Bank project with the entity in question.

A1.13 Evaluation

Evaluation is defined as the process of assessing the performance of completed projects, programmes, and other Bank business activities through a systematic analysis of their outputs, outcomes, expected impact, with the ultimate objectives of providing accountability and deriving lessons of experience.

Project evaluation, the core of evaluation work, has two basic objectives which are to assess the results, both intended and otherwise, of the Bank's portfolio of projects and programmes, and to determine whether there were significant lessons to be learned from past experience in order to ensure more successful future operations. A well designed system for project evaluation also generates confidence that the Bank has the means to learn from the strengths and weaknesses of its completed operations and of those of other international financial institutions.

The independence, with which project evaluation activities are carried out, which secures the necessary objectivity and transparency, is a vital element of the evaluation process and, for this reason, is conducted by a separate department, the Evaluation Department (EvD). The Chief Evaluator, the head of EvD, is directly and only responsible to the Board and only takes his/her instructions from the Board of Directors as a whole (and not from any Board Committee, except as may be provided under the Terms of Reference of any such committee, or from any individual Board member).

The basic methodology for carrying out a project evaluation normally includes reviewing the operation file, assessing the financial and where applicable economic analysis presented in the Board reports at appraisal and in the XMRs at the time of post evaluation. Apart from close communication with the respective operations team, the evaluation is based on extended contacts with the client, the external auditor and other local contacts which are key to a project's success.

One year and a half after last disbursement of a loan and approximately two years after disbursement of an equity participation, the operations team prepares a self-evaluation report, the Expanded Monitoring Report (XMR). This report highlights the implementation and operational experience, gives an assessment of the project's performance and prospects, and reviews the project's transition impact and present lessons learned.

For selected operations, EvD produces an Operation Performance Evaluation Review (OPER) which provides an independent evaluation of the project's outcome, the evaluation findings and the lessons learned. To increase the evaluation coverage of operations EvD also selects a number of projects on which an XMR Assessment is carried out which allows validating the findings of the XMR. In selecting projects for evaluation the Bank takes a sample of projects "ready for evaluation" or having reached "early operation maturity". The sample taken is large enough to generate a sufficient number of quality lessons learned and to present an adequate level of representation to be able to reach more general conclusions on the portfolio as a whole. The minimum annual evaluation coverage ratio is 60% of operations ready for evaluation. During 2008, EvD developed a new approach based on random sampling, which will most likely lead to a falling coverage ratio in the coming years.

In compliance with its fiduciary responsibility towards the contributors to its Technical Cooperation Funds Programme (TCFP) and other grant funding facilities, technical cooperation (TC) operations are subject to a diligent appraisal, monitoring, self-evaluation and independent evaluation process. EvD carries out (a) in-depth evaluations of individual or a group of TC operations in the form of an operation performance evaluation review (OPER) which involves a field visit and occasionally consultant input (six annually); and (b) a desk-study-type assessment of 20 project completion reports on TC operations. TC operations are also assessed when Bank Programmes are evaluated that are mainly supported by donor funding. So far, 59% of the volume of TC operations has been covered by EvD through direct or indirect evaluations.
EvD produces an Annual Evaluation Overview Report (AEOR) on its activities, and key evaluation findings and presents quality management suggestions. Together with the bi-annual Monitoring Reports (MRs) prepared by the operations teams, these documents are the Bank's basic instruments of accountability for projects performance and provide the building blocks for periodic overview of the Bank's portfolio performances. The AEOR is provided directly to the Board of Directors.

EvD also prepares special studies which are integrated evaluations of Bank project, TC and policy dialogue initiatives at sector level and country level. These studies follow the Development Assistance Committee (DAC) principles of evaluation which include relevance, effectiveness, efficiency and impact criteria. The studies do not systematically include performance ratings. They rather tend to focus on lessons of experience to help guide future Bank initiatives in the above mentioned areas.

An important function of project evaluation is the dissemination of lessons learned to the staff in the Bank's operational department so that the lessons can be used to improve future project design. In each of the project documents that are presented to the Board for approval it is described in which way key lessons learned are used in the projects. This can be considered an important accountability tool as the Board is made aware that the Bank learns from its experience.

The Bank is also exercising the necessary transparency towards the general public by publishing evaluation outcomes on its Website, thereby following EBRD's Public Information Policy (PIP). The following evaluation reports are disclosed, subject to editing on commercial confidentiality:

- Summaries of operation performance evaluation review (OPER) reports
- Evaluation Special Studies
- OPER reports on TC operations
- The Work Programme Final and Completion reports of EvD
- The Annual Evaluation Overview Report

Management's Comments in respect of any of the foregoing documents (summaries, reports etc.) are posted in full on the Bank's website at the same time as the document to which they relate. The document is also edited in order to avoid the identification of client companies and to preserve commercial confidentiality.

A1.14 Public information policy

The EBRD is committed to enhancing transparency and accountability and fostering good governance in all its activities. The *Public Information Policy* sets out how the EBRD discloses information and consults with its stakeholders so as to promote better awareness of its strategies, policies and operations.

Basic Principles

The Public Information Policy is underpinned by the following basic principles:

- *Transparency*. The EBRD is guided by the underlying presumption that, whenever possible, information concerning the Bank's operational and institutional activities will be made available to the public in the absence of a compelling reason for confidentiality.
- *Accountability and governance*. The EBRD is committed to reinforcing its accountability to shareholders, and to ensuring high standards of corporate governance.
- *Willing to listen and receptive to comment*. Through its commitment to open communication, the Bank demonstrates its willingness to listen to third parties so as to benefit from their contributions to its work in fulfilling its mandate.
- *Safeguarding the business approach to implementing the mandate*. A business-sensitive partnership with sponsors and contractual counterparties is necessary to allay concerns about client confidentiality which could affect their willingness to work with the Bank.

Review cycle

The Policy is reviewed triennially. While a fourth review was undertaken in 2005/2006, it was decided to bring forward the fifth review by one year to 2007/2008 to coincide with the review of the Bank's *Environmental and Social Policy*, give its implications for the *Public Information Policy*.

2005/2006 review

The 2005/2006 review was wide ranging, including internal and external consultations, benchmarking with other IFIs, a website posting of the draft proposals, and a meeting with representatives of NGOs. The review resulted in the following new elements:

- the introduction of two new categories of information to be disclosed: *General Institutional Information* and *Accountability and Governance* (in addition to the already existing categories of *Project-related Information* and *Policies and Strategies)*;

- the widening of scope of information to be made available to include publishing *Minutes of the Board of Directors Meetings*;
- the encouragement of public participation in the development of *Country Strategies* by posting draft strategies on the Bank's website for 30 days with an invitation to comment; and
- the provision of *Project Summary Documents (PSDs)* to be made available in the relevant official national languages.

Following the launch of the revised policy, two additional improvements to the policy were approved by the Board: (i) *Implementing Procedural Provisions for Information Requests and Appeals;* and: (ii) *Clarifications regarding "confidential information" of the Public Information Policy*.

2007/2008 review

The 2007/2008 review benefited from consultations with civil society representatives at the 2007 Annual Meeting in Kazan, followed by a series of public meetings with members of civil society in Budapest, Belgrade, Moscow, Tbilisi and Bishkek, as well as website posting of the draft of the revised Policy. This produced many practical comments which helped in formulating the improvements to the new Policy.

The revised *Public Information Policy* was approved by the Board of Directors on 12 May 2008. Changes which were introduced included the following:

- the public comment period for draft Country Strategies was extended from 30 to 45 days;
- details of the information to be made available in Project Summary Documents (PSDs) were identified. Due to the interest shown in the TC element of projects, the Policy committed to include basic TC information in PSDs;
- there was a new commitment to explore means other than the web to disseminate information;
- some qualifying words in the text, which weakened existing commitments, were removed;
- the organigram of the Bank on the web was to be upgraded to show the relationship between the various departments;
- There was a commitment, in conjunction with the Environmental and Social Department, to conduct a training programme for PIP implementation in ROs and at HQs.
- the Board-approved Clarifications Regarding Confidential Information were incorporated into the Policy replacing the "confidentiality" sections in the previous Policy; and
- the Board-approved Implementing Procedural Provisions to handle requests from the public for information and a mechanism to deal with appeals against refusals of such requests were incorporated into the Policy.

Implementation

The Secretary General oversees and verifies compliance with the Policy. Management reports to the Board on implementation on an annual basis and the findings are made public on the Bank's website.

APPENDIX 2: CRR3 IMPLEMENTATION EVALUATION

EXECUTIVE SUMMARY
EVALUATION DEPARTMENT

In the framework of the preparation of CRR4, the Board and Senior Management expressed interest in EvD providing inputs to the analytical framework, which will guide the Board discussions on this subject. While considering all the objectives during the evaluation of CRR3, EvD will concentrate on items that it considers as salient features for lessons learned purposes.[25]

A2.1 Achievements of CRR3 objectives

In the positive context of 2005, the Bank had decided to maintain the broad strategic orientation of CRR2. From this strategic orientation, the Bank derived a number of operational objectives in terms of annual business volume for 2006-2010 and the portfolio level in 2010, the geographic composition indicating a shift towards intermediates and Russia, and the corresponding growth in the number of Bank operations.

In terms of the main portfolio aggregates, the Bank has reached so far the operational objectives that were underpinning its strategic orientation, and even went somewhat beyond. In indicative terms, the portfolio was to attain a level of EUR21.9bn by 2010. It already reached EUR21.5bn in 2008. The share of the early and intermediate transition countries and Russia in the portfolio had to grow to about 87 percent by 2010. By 2008 this share was already 83 percent, and has therefore remained on track. The number of operations of the portfolio was to grow significantly from 1,200 in 2005 to 1,600 by 2010. This number was around 1400 in 2008, in the line of the 2010 objective.

With regard to the business volume performance, the Bank went well above its original objective. The Bank was to achieve an annual business volume within an operating range of EUR3.3bn to EUR3.9bn, representing an increase in cumulative business volume of 23 percent compared to that projected for the CRR2 period. In fact, the cumulated business volume from 2006 to mid 2009 was EUR19bn compared with a base case projected volume of EUR13bn, *or 46 percent higher*. Two events led the Bank to produce a higher-than-projected business volume and increase its risk exposure in the areas of sound banking and transition impact, in EvD's view, beyond the ranges of CRR3. These events originated in the business environment: strong expansion between 2006 and 2007, followed by a sharp downturn triggered by the global crisis between 2008 and 2009.

During this period of high growth in the business environment, departure from the original business volume objectives occurred across a number of sectors. The corporate sector was projected to account for 45 percent of the cumulative business volume over CRR3. Correspondingly, the financial sector share was projected to decline to 24 percent of the

[25] This Evaluation Note is a summary of an Evaluation Paper prepared by EvD in November 2009 as a contribution to the CRR4 Report.

cumulative business volume. However, the share of the financial sector grew to reach a share in the business volume almost twice as high (42 percent), *exposing the Bank to operational risks attached to financial sector operations beyond what the Bank intended to carry and making the Bank more vulnerable to any additional systemic risk that could result from a regional cyclical downturn originating in the financial sector*.
The other determining event that generated additional risk for the Bank was the sharp downturn of 2008. Most probably, this event alone would not have affected the overall implementation of CRR3 had the Bank used the circumstances to correct the volumes carried above target in the expansionary years. This raises a question whether Bank's operations were reasonable given the amount of capital. The formal check had been done in mid-2008. Arguably, such a test could have been done earlier, at the end of 2007. However, the economic situation was still difficult to read at that time.

In November 2008 (during the Board retreat), the Bank received a message that it needs to act differently to respond to the crisis. It was emphasised further in April 2009, when the international community through the G20 encouraged the Bank to intensify its crisis response. The Bank was to contribute to an MDB coordinated effort that was to help counteract the sudden shortage of world liquidity, with emphasis on supporting debt restructuring and recapitalisation in all sectors.

Since the beginning of 2008, the Bank has been responding very actively to the crisis situation in adopting a wide range of interventions. The Bank's operational crisis response has been flexible, transaction-based and allowed for a rapid and significant commitment of resources where needed. Rather than reducing its exposure, the Bank maintained a share of its business in the increasingly fragile financial sector. As a consequence, in spite of the diversification safety benchmark recommended in CRR3, the 40 percent share reached in the financial sector between 2006 and 2007 was maintained during the crisis period. This new level of financial risk originated from changes in Bank exposures in both sector and geographical dimensions.

A2.2 Associated transition impact

During the period of implementation of CRR3, the share of projects with high transition risks increased significantly. Although the Bank portfolio has been moving towards geographical areas where transition is more challenging, there have been new elements that put more weight on the risk side such as (i) in moving its businesses volumes above the CRR3 benchmarks, the Bank entered areas where the design and functioning (transition) component of additionality became harder to justify, unless the Bank would take higher risks; and (ii) in keeping high business volumes during the current crisis period, the Bank was led to present new projects that were more risky, including transition impact which is more conducive to materialise in favourable. As a result, although the effect of inflows of new CRR3 projects on the score of the overall transition portfolio stock was lower, it was over-compensated by upgrades of ongoing projects in 2007-08 due to the favourable business environment. The effect of inflows in the first half of 2009 reinforced the change of the overall stock performance in 2009, when the effect of upgrades became negative as a result of the sharp financial and economic downturn. Thus, the overall effect on transition impact remained positive[26].

A2.3 Lessons learned from Evaluation during CRR3

The following are some key lessons learned identified by EvD in the course of evaluation work in the CRR3 period, and relevant to broad strategic issues arising from developments in that period.
The Bank anticipated that moving operations to the East and South would expose it to more fragile financial and transition outcomes, which had to be closely monitored. The Bank had also a "downside" cyclical scenario in CRR3. However, CRR3 did not really foresee the following risks, which are much easier to detect ex post: (i) the eventuality that in order to remain additional in a strong phase of expansion, the Bank might move into areas which require taking on more risk ; (ii) the effects of a deliberate attempt to enter into more cyclically risky operations sectors (such as financial intermediation) or regions/countries (Russia during the expansion period of 2006-07); and (iii) country risks that may develop from inside but also from a chain of reactions coming from outside.

Country risk. Given the higher than projected Bank business volume to a large sector, and a large country of operations in the early years of CRR3, it appears appropriate to look into the way the country risks have been estimated during the financial boom of 2005-2007 and the crisis of 2008-2009. It is noticeable that these indicators for major countries in the region have remained relatively neutral to the effects of the financial sector global expansion and the crisis: for example Russia's rating stayed at level 5 during 2005-2009, and Ukraine was downgraded by one point in 2009. EvD understands that for many reasons a country risk rating should not be reduced to a financial market indicator. However, EvD finds that the apparent rigidity of country risk ratings in periods of rapid expansion and strong recession is debatable.

Market frameworks. Major emphasis on competition and market expansion in the implementation of CRR3 left room to adverse project selection and issues in project implementation. In spite of the Bank policy guidance for the financial sector, more operational emphasis should have been given on building confidence through stronger market frameworks in the financial sector. In practice, it appears that focusing on financial deepening in its operations the Bank took more risk with regard to financial stability. Despite many attempts to deal with this issue, which are well recorded in Financial Sector Intermediary Reports, the impact of direct policy dialogue to improve market frameworks with central banks, national regulators and other relevant government institutions has been limited in some cases.

Local currency versus foreign exchange. The Bank has already attempted to put more emphasis on lending in local currency. Cautions from the Operational Guidelines on Foreign Exchange exposure in Bank lending operations do not appear to contain a high wave of foreign currency lending in recent years. For example, a 2009 OPER found that the

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[26] In addition, higher number of projects during the CRR3 period may also contribute to a higher overall transition impact achieved.

development of Bank lending in foreign exchange increased the client's foreign exposure beyond prudent limits. At the same time, greater reliance on local currency was set on several occasions as a Bank objective in CRR2, CRR3, in preparatory papers for CRR4, and in crisis response documents. The experience varied widely across countries of operation. For example, operational objective found its way down in Russia, where rouble lending picked up over the recent years. However, for many other countries lending in local currency was not that successful for a number of reasons, such as (i) the Bank's promotion of local currency schemes were limited: (ii) there was little interest at the project level, and (iii) the foreign/local interest rate differential may have given the wrong incentives. Recent initiatives from Banking and Treasury, together with OCE work suggest that the current situation with local currency lending in countries of operation may turn around reasonably fast if proper measures are taken.

Banking sector supervision has also become an issue**.** In the early 2000s, the Bank recognised that banking supervision was weak in Russia and took policy dialogue initiatives in 2005-06 to help remedy the situation. However, there appears to have been only minor follow up since then, while nevertheless both numerous and large operations have continued to be handled in the financial sector. More generally in the region, the Bank continued to promote cross-border operations in the region during CRR3 without major concern for the quality of cross-border banking supervisory arrangements.

Corporate integrity risks. A higher than projected level of Bank interventions in Russia during the expansion period 2006-07 was associated with priority given to large enterprises in the corporate sector and raises a question of acceptable levels governance and integrity risks. In 2007, EvD raised a question of adequate information on large shareholders. More recently, an OPER on a project for a large company found insufficient analysis of integrity in Bank project preparation.

The ***pattern of reforms*** in the ***infrastructure*** sector has been assessed in EvD project evaluations during the CRR3 period, and the analysis here is valid for a sample of selected OPERS that carry useful lessons of experience, without any attempt on generalising conclusions. EvD raised some concerns, especially in Russia**.** One of the OPERs found that the policy dialogue has often been limited to the Ministry of the client company, with no involvement of key counterparts in other ministries. The same evaluation noted that the legal framework for the PPP was not yet conducive to operations leading to efficient private sector participation and that the TC legal advice provided by the Bank was not coordinated with advisory activities carried by other stakeholders. In addition, the Bank's TC interventions appeared to arrive too late to be fully effective. Another recent OPER found that energy projects *taken individually* carried little transition impact at the sector level in Russia. The same group of projects taken as components of a larger reform programme might have carried more transition impact on sector and economy levels. However, the Bank did not have a really integrated approach to transition impact at the sector level that would show the extent to which each project could contribute to reforms in the sector.

A2.4 Capital and staff resources

The Bank's capital. Despite close monitoring of CRR3 implementation by Management, the Bank went beyond its projected range of business volume during the periods of expansion and current crisis, without modifying the level of capital and staff resources to deal with the new situation. The Bank has been departing from the logic of CRR3, which was to link resources with a specific configuration of business level and composition. The due diligence work in CRR3 on capital adequacy lost considerable relevance since 2008 because: (i) the amplitude of the financial crisis is by now above the level of the maximum downturn scenario; and (ii) the stress exercises had been run without integrating the foreign exchange risk that became a major factor in 2008.

The Bank staff. The CRR3 initial report already noted that, although the cumulated business volume in CRR2 had exceeded projections by 27 percent, the Bank maintained in practice a zero real budget growth, therefore significantly raising productivity. The CRR3 report added that cost pressures and staff requirements would increase as the Bank implements CRR3 and, as a consequence of the significantly expanded workload, a measured degree of staff resource growth was necessary. In terms of implementation, the total of Bank funded regular and local staff was 1309 on 30 June 2009, as compared with 1126 in December 2005, implying an increase of staff of 183 staff, or 16 percent from end-2005 to mid-2009. Meanwhile, the Bank continued to run its business well above projected levels, to the point of reaching in mid-2009 a cumulated business volume 46 percent higher than originally foreseen. Therefore, despite a significant staff growth, the Bank has been again putting strong pressure on staff productivity, which potentially could reduce the quality of the Bank's work.

A2.5 Conclusion

Regarding the main portfolio aggregates, the Bank has reached so far the operational objectives that were underpinning its strategic orientation. However, the analysis is pursued beyond the broad aggregates and start focusing the decomposition of the business volumes by subcategories of countries and sectors over time, some imbalances may have led the Bank to a risk exposure beyond what was foreseen in CRR3. EvD is recommending the following initiatives for financial, corporate and infrastructure operations that would strengthen the institution in better weathering the financial and transition impact risks in the CRR4 period:

- ***Country risk***. EvD finds the apparent disconnect of country risk ratings from a well established global indicator of financial market trends to be debatable and recommends a further internal review of the issue.
- ***Financial stability***. The Bank should put more emphasis on strengthening market frameworks through policy dialogue in coordination with other IFIs.
- ***Client foreign exchange exposure***. The Bank should conduct more analysis and provide operational guidance to contribute to the sound development of local capital markets, while providing appropriate TC.
- ***Banking supervision***. In collaboration with other IFIs, the Bank should obtain stronger commitments from national financial regulators on banking supervision including cross

border supervisory arrangements in countries of operation. At the same time, the Bank should make decisions with regard to its Financial Institution projects based on any existing level of the quality of banking supervision in countries of operation.

- ***Corporate integrity***. The Bank should continue strengthening its governance and integrity analysis before project approval, as well as diligently follow up over the life span of investment operations.
- ***Policy dialogue***. The Bank should better identify key stakeholders at the national and sectoral levels to improve its policy dialogue with countries of operation.
- ***Integrated approach***. The Bank should build a new approach with committed counterparts, programme success indicators and covenants for loan disbursement to promote sector reforms that can be associated with its investment and TC operations.
- ***Technical cooperation***. The Bank should improve further its system of establishing systematic TC benchmarks to track the progress of Bank support to reforms especially in the financial and infrastructure sectors.

Beyond the above recommendations to further strengthen institutional capacity, the Bank will face higher risk levels resulting from the implementation of CRR3. A corporate lesson to learn from the implementation and impact of CRR3 is that when the Bank is moving beyond its operational financial targets in a more difficult business environment, it should be prompt in openly discussing the adequacy of its capital and human resources.

APPENDIX 3: NUCLEAR SAFETY ACTIVITIES

The nuclear safety mandate of the EBRD dates back to 1993 when the Nuclear Safety Account (NSA) was established at the EBRD. Since then the mandate has broadened and pledges have grown from the initial €100 million to close to €3 billion to the six different nuclear safety grant funds. EBRD remains the only international financial institution with direct involvement in nuclear safety.

The objectives and priorities of the six funds are an intrinsic part of the nuclear safety agenda of the international community. The focus of the NSA was to improve nuclear safety of the first generation of nuclear reactors in the region in line with the decisions of the 1992 G7 Summit. The NSA programme for Ukraine and the Chernobyl Shelter Fund (CSF) as well as the K2R4 were the result of the 1995 Memorandum of Understanding between the G8/EU and Ukraine aimed at closure of Chernobyl and support for the compensation of this closure. The three International Decommissioning Funds (IDSFs) for Bulgaria, Lithuania and Slovak Republic were established at the EBRD in 2001 as an initiative of the European Commission to support the accession candidate countries in the process of safe closure and decommissioning of the high risk reactors and, equally, in measures in the energy sector consequential to the closure.

The Northern Dimension Environmental Partnership was initiated by the EC, Russia and Scandinavian countries with the objective of creating an efficient instrument for the financing of environmental projects in the North West Russia. NDEP's Nuclear Window with a specific objective of providing grant financing for the projects dealing with the nuclear legacy of the Soviet Nuclear Fleet became operational in 2003.

The operations of the fund are fully externally funded (the Rules of all funds, approved by the Board, exclude the utilisation of ordinary capital resources of the Bank or the Special Funds resources). While the European Union and the G8 countries are the largest donors, more than 25 governments have contributed to the funds making them truly multilateral grant facilities. At the end of 2009 commitments to the three IDSFs reached €1.5 billion, mostly from the EU, with the clear prospect of further increases within the EU's 2007-2013 financial perspective. The contributions to the CSF are close to €900 million while cumulative contributions to the NSA exceed €350 million. In 2008 EBRD shareholders decided to allocate $135 million of the Bank's net income to the key Chernobyl projects financed from the CSF and NSA (New Safe Confinement (NSC) and Spent Fuel Storage (ISF-2)). Both CSF and NSA will require additional donor contributions. Contribution agreements for the NDEP Nuclear Window total €150 million.

NSA tasks in Bulgaria, Lithuania, Russia and Ukraine, with the exception of the two decommissioning support facilities in Chernobyl, have been completed with a significant positive impact on nuclear safety. The objective of early closure of high risk nuclear reactors has been achieved in the EU and Ukraine, starting with the closure of Chernobyl in 2000 and completed with the closure of Ignalina 2 in 2009. Projects financed by the NSA, CSF and IDSFs largely contributed to closure decisions. The ongoing decommissioning of these plants remains, however, a long term task. The CSF and NSA have entered their final stage with designs to be completed in 2010. Successful stabilisation of the existing Chernobyl "sarcophagus" in 2008 reduced the risk of collapse. Environmental risks will be eliminated when the NSC is completed in 2013. Key projects under the Nuclear Window of the NDEP have been launched in accordance with the Strategic Master Plan for the Russian NW completed and endorsed by Russia and donor governments in 2008. The project pipeline focuses on threat reduction through safe storage and removal of spent nuclear fuel from the region.

The synergies between the nuclear safety funds and the Bank's operational activity have developed further. Support from other Bank departments adds substantively to the ability of the nuclear safety team to deliver against its Fund's management mandate. Nuclear safety expertise, in turn, has assisted Bank's operations where nuclear safety or nuclear sector knowledge in the region plays a role. The K2R4 safety upgrade project, which was almost complete at the end of 2009, is a clear example of this benefit. Its success in Ukraine also provides a sound basis for safety upgrading of all nuclear power plants in Ukraine. The nuclear safety line in the Special Shareholders Fund financed an assessment of feasibility of this project and several other potential initiatives related to nuclear safety. Opportunities to develop an actionable plan for dealing with the legacy of uranium mining in Central Asia are now actively pursued together with the EU, IAEA, UN and other involved institutions and donor governments.

IDSFs, with their mandate for grant co-financing in the energy sector and for energy efficiency, have created further synergies. In Bulgaria, in particular, energy savings achieved with Kozloduy IDSF grant co-financed energy efficiency credit lines, district heating upgrades and 100% grant funded energy efficiency projects for public buildings have significantly offset the loss of generating capacity caused by the closure of Kozloduy reactors. Similar models have now been implemented in the Slovak Republic. The focus in Lithuania has been on security of supply. An EBRD loan will co-finance, together with a €165 million grant, a modern 450MW gas fired plant substituting in part for the closure of Ignalina. The environmental upgrading of the Lithuanian Thermal Power Plant supported by a €90 million grant was completed in 2009 with the same purpose.

Significant challenges lie ahead, some beyond the Bank's control, in both the political and project environment. In Ukraine a stable institutional environment will continue to be vital for the implementation of Chernobyl programmes. Their continuation and completion require further immediate political and financial support effort led by the G8 and the EU. Having achieved the milestone of closure of the high risk reactors in the new EU member states, the key objective is to create a sustainable basis for continued decommissioning of these plants working with the EU and the three governments. This objective includes completion of major decommissioning support facilities as well as the creation of effective decommissioning management and governance arrangements. Nuclear projects in North West Russia, with specific problems of classified sites, climatic and other new challenges, will certainly require a major effort. The performance of contractors (and clients and PMUs) will remain a challenge which often puts the Bank in a delicate role of a broker between the parties.

Key objectives include:

- With political and financial support of donor governments achieve completion of the NSC in 2013 and other related Chernobyl projects on corresponding schedule.
- With additional donor support, achieve completion of the ISF-2 on a schedule supporting the transfer of Chernobyl fuel, tentatively in 2014.
- Working with the EC and the governments of Bulgaria, Lithuania and Slovak Republic help create effective decommissioning management and governance arrangements to ensure unimpeded progress of the three decommissioning programmes.
- Achieve completion of key investment projects supporting the decommissioning schedules such as the fuel storage projects in Lithuania and Bulgaria and waste management or repository projects in all the three countries in the period between 2010 and 2015.
- Continue building on the successful energy efficiency model in Bulgaria through new projects in both Bulgaria and Slovakia. In Lithuania support completion of the new gas plant by 2012 and in Slovakia, over the next five to six years, completion of transmission and distribution projects consequential to the closure of Bohunice.
- Commence implementation of large infrastructure projects in North West Russia and establish efficient monitoring and management mechanism with Russian authorities in 2010.
- Support in assessment and eventual development and implementation of the Ukraine Nuclear Safety Upgrading loan project and any other nuclear safety related initiative.

The direction of the six existing funds is not expected to change in the foreseeable future. However, as in the past, new nuclear safety related initiatives could be presented to the Bank.