Board of Governors
2009 Annual Meeting
London, 15-16 May 2009

FIGHTING THE CRISIS, PROMOTING RECOVERY AND DEEPENING TRANSITION

Accompanying letter from President Mirow is attached

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GOVERNORS AND ALTERNATE GOVERNORS

17 April 2009

Dear Governor,

During two decades of transition, the EBRD's region of operations has witnessed extraordinary change. Multi-party democracy and pluralism have taken hold, and market-oriented reform has been a powerful driver of growth and prosperity. The EBRD was set up in 1991 to promote these changes and can claim a small portion of the credit.

This year's Annual Meeting of the Bank, however, takes place against a backdrop of economic turmoil. The Bank is contributing to an effective international response. At a time when commercial finance is shrinking the Bank is making the most of its capital. The Bank's first-quarter level of investments has been higher than ever before, exceeding last year's level by over 60 percent. By addressing critical vulnerabilities the Bank is working to create confidence. And it has helped build a common platform for action among IFIs, regulators and private groups in the banking sector, contributing its client relationships, presence on the ground and ability to take direct commercial risks.

While fighting the crisis we also need to think ahead to promoting recovery and transition. In so doing, we must draw the right lessons from the crisis and from two decades of transition to market economies, and conduct a careful assessment of the Bank's competencies. We should also build on the success of the Bank's climate change work to promote a sustainable recovery. For our meeting I have prepared a background paper on these questions (enclosed), proposing priorities for the medium term, which has been approved by the Board of Directors.

These are the issues that I would like to discuss with you at the Governors' Roundtable during the Annual Meeting:

- Are Governors satisfied with the Bank's crisis response?
- Are we drawing the correct lessons from the crisis and the transition process so far?
- Do the proposed medium-term priorities reflect and support the wider objectives of shareholders, including those expressed by the G20?
- The crisis response will inevitably expose the Bank to high risks, and a sizable contribution to recovery may test the Bank's capital. Do we have your support in taking these risks, and in reviewing the implications for our capital?

Based on your guidance, we will further refine our crisis response and review the Bank's medium-term operations and capital resources ahead of the 2010 Annual Meeting.

The impact of the crisis and the EBRD's response

The crisis has its origins outside the transition region, but the global turmoil has in several countries combined with local vulnerabilities: a strong dependence on capital inflows, foreign currency denominated debt, and in some cases excessive reliance on commodities. The Bank is now projecting a decline in regional GDP of between -3 and -5 percent for 2009, with further downside risks, if currency and financial sector problems are not brought under control. Shocks may spread from crisis hotspots, since the region is so deeply integrated with the wider European and global economy. There is also a risk that important transition achievements may be reversed. Solutions will require an orderly adjustment to lower external financing, strengthening of bank balance sheets and reduction of foreign exchange debts of companies and households.

Primary responsibility for taking action of course lies with the countries themselves, but regional and global problems require regional and global solutions. G20 and EU leaders have taken important steps in that direction. Let me focus here on the role of the EBRD.

The Bank has attributes that are very valuable in these circumstances, in particular the skills and capacity to take direct risks, ability to provide equity as well as liquidity and long-term funding (including in local currencies), direct access to the private as well as the public sectors, and strong on-the-ground presence in all 29 countries of operations. It is the largest single investor in the region and has a network of existing client relations that it can build on for a rapid response, including shareholdings in some 60 banks, lending relations with 300 financial institutions, and more than 1,000 existing clients in all sectors.

Given the shortfall of commercial funding, the Bank has raised its total business volume target for 2009 to €7 billion, which, if implemented, would exceed the level in 2008 by one-third. Some countries that were expected to graduate by 2010 are likely to draw on the Bank's support for as long as required to help manage the crisis. The Bank is ready to provide that support.

The Bank's crisis response is focused on sectors that are critically affected and builds fundamentally on its private sector competencies. Specific operational initiatives that have been launched include:

- *Bank recapitalisation and liquidity support*, particularly for systemically important banks, aimed at ensuring continued funding for the real economy.
- An almost doubling of the *Trade Facilitation Programme* (to €1.5bn).
- Financing for critical *energy and infrastructure* projects left unfunded by the market, in a systematic co-financing effort with other International Financial Institutions (IFIs), in particular the EIB.
- A *Corporate Support Facility,* providing quick-disbursing financing to corporations.

Further initiatives are under preparation and we will continue to adapt our instruments as the crisis evolves. We are particularly focussed on helping catalyse commercial

lending back into the real economy. This requires carefully pricing our loans and guarantees in a long-term, risk-reflective manner that entices entry of commercial banks once lending conditions improve.

The Bank has a pipeline of potential crisis response projects that is significantly larger than its €7 billion investment target for 2009. While it has the financial capacity to exceed this target, any decision to do so would have to balance the immediate crisis response against the Bank's medium-term capital adequacy, and be fully cognizant of the risks involved.

Promoting recovery and deepening transition

The course of the crisis is difficult to predict. Nevertheless, it must be assumed that, following a crisis management period in 2009 and 2010, cross-border financial flows will not return soon to the levels experienced in the first half of the decade. The period 2011-2015 is likely to be dominated by efforts to revitalize investment and economic activity in the region within this harsher environment. At the same time, the underlying growth potential of the region will remain very high and investment needs significant.

The Bank must start now to plan how it can be most useful and effective in helping to lay the bases for recovery and to reinvigorate the region's transition. This is because today's crisis response has implications for the Bank's sustainability, and because the Bank needs to prepare itself organizationally during the coming months for these challenges. Based on your guidance, we will thoroughly review the transition priorities, our medium-term operational, financial and resource framework and the Bank's capital adequacy, and return to you next year for the Fourth Capital Resources Review (CRR4).

The Bank's contribution to economic recovery should draw on the lessons from the crisis and of transition so far. A key lesson is that transition is about building markets and the private sector, which have served the region well, but that it is also about improving the quality of both public and private institutions and ensuring that they work well together. These are not new insights, but the abundant liquidity of the past years allowed them at times to be sidelined. I propose to derive operational implications from these lessons for the Bank over the coming months, with a focus on the most effective ways to combine project finance, technical cooperation and policy dialogue.

The Bank's contribution should also be based on its particular competencies while working closely together with other IFIs. Having conducted a careful examination of these competencies over the past few months I propose that the Bank should give emphasis to the following four areas in developing its medium-term operational strategy:

- In the *financial sector*, the Bank should, in addition to deploying its existing range of equity and debt instruments, give further impetus to developing domestic capital markets and the expansion of local currency lending. The Bank is also well placed to help strengthen its clients' risk management frameworks and practices.
- In the *enterprise sector,* the Bank should continue to provide risk capital and financial access for SMEs in support of economic diversification and

competitiveness, promote high-quality corporate governance, and support the development of value chains in agriculture and agribusiness.

- Building on the success of its Sustainable Energy Initiative, the Bank should further expand its work on *energy efficiency and climate change mitigation*, which is being mainstreamed across all sectors of activity in support of enhanced energy security, economic competitiveness and lower carbon emissions in the region of operations.
- In the *energy, municipal and transport sectors*, the Bank should use its specific skills to support balanced development, sub-sovereign financing solutions and mixed public-private financing instruments, and build capacity of local authorities while targeting environmental improvements and strengthening regulatory frameworks.

Successful implementation of this strategy, which emphasises the need for institutional quality throughout, will require deployment of significant technical cooperation. The Bank has a strong track record in this area and has benefited from the generous support of donors. The EBRD Shareholder Special Fund (SSF), established last year and funded from net income with your approval, has given the Bank additional impact and flexibility. The Bank will need continued strong donor commitment and we will also need your support to making the SSF a predictable source of funding for technical cooperation.

Making efficient use of the Bank's capital

Recognising that the Bank has been endowed with a strong capital base, the Board of Directors' recent decision to adjust the Bank's statutory gearing ratio yields sufficient headroom for a robust crisis response. Based on a thorough capital adequacy analysis, we can be confident that over the period 2009-10 the Bank would be able to prudently scale up its crisis response even beyond existing plans if requested by shareholders, while preserving its AAA rating.

Nevertheless, as a consequence of the crisis, the Bank is likely to incur a substantial increase in impaired equity and loan assets. While the Bank is uniquely versatile in its instruments and strictly observes sound banking criteria, the fact that it takes direct commercial risks with a high country and regional concentration gives it far greater exposure to systemic disruptions than other IFIs. Therefore, while the Bank's capitalisation is strong, it is also needed. It is crucial that, as the Bank develops its crisis response, it can count on the full commitment and support of shareholders in the face of these risks.

In the CRR4 period (2011-15), the scope for future investments and lending will need to be carefully assessed against the Bank's available capital. Management and the Board of Directors will conduct this exercise over the coming months. The Bank's capital and prudential ratios could impose constraints on the level of activity during the CRR4 period, all the more so if shareholders ask for a significantly higher crisis response and if impaired assets were to rise. The trade-offs that this implies will need to be evaluated.

As for other economies around the world, the global crisis is a serious setback for the transition region, but there can be no doubt that the region's confidence and dynamism

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will reassert themselves. I very much look forward to discussing with you personally how we can help make this happen.

Yours sincerely

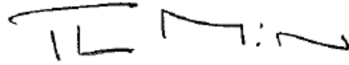


TABLE OF CONTENTS

INTRODUCTION **1**
1. EBRD CRISIS RESPONSE PROGRAMME: BRIEF OVERVIEW **2**
2. TRANSITION: APPLYING THE LESSONS OF EXPERIENCE **3**
2.1 20 years of transition 3
2.2 Balancing state and markets 5
2.3 Impact of the global crisis 7
2.4 The short- and medium-term transition agenda 8
Financial sector 9
Corporate sector 10
Energy security and climate change 11
Infrastructure 12
Further transition challenges 12
BOX 2: TRANSITION – APPLYING THE LESSONS OF EXPERIENCE 13
3. EBRD COMPARATIVE ADVANTAGE **13**
Mandate features 14
Institutional features 14
Operational features 15
BOX 3: EBRD COMPARATIVE ADVANTAGE 18
4. EBRD CORE COMPETENCIES **18**
4.1 Financial sector competency 19
4.2 Corporate sector competency 21
4.3 Energy competency 23
Energy Efficiency/Climate Change 24
Nuclear safety 25
4.4 Infrastructure competency 26
Support to local government 26
Transition oriented infrastructure 27
BOX 4: CORE COMPETENCIES 29
5. IFI COOPERATION **29**
5.1 An opportunity for strengthened cooperation 29
5.2 Cooperation experience 30
5.3 Principles of cooperation 31
5.4 Focus areas for strengthened cooperation 32
BOX 5: IFI COOPERATION 33
ANNEX: SELECTED PROPOSALS FOR DEEPENING COOPERATION AMONG IFIS **34**

INTRODUCTION

Twenty years after the fall of the Wall and close to 18 years after the inauguration of the EBRD, the region of operations, our understanding of the transition process and the Bank itself have evolved. The transition experience and especially the harsh test of the global financial crisis offer a broad range of lessons. They have given rise to a careful reassessment of priorities and, indeed, 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, and to do so in effective cooperation with other IFIs. The crisis is presenting both more urgent needs and significant new opportunities to do so.

The region's immediate priority is to confront the crisis. The initial crisis response, like elsewhere, is directed at the effects of financial sector disruption, at preserving external balance and at supporting aggregate demand. The Bank can make a valuable contribution to the former, but is neither sizable enough nor mandated to address macroeconomic challenges.

As described briefly in section 1, the Bank has both scaled up and refocused its operational targets. A significant share of its operations in 2009 will, often in coordination with other IFIs, be directed towards the strengthening of bank balance sheets, the extension of intermediated "life-line" credit facilities for SMEs, a strong boost to its trade finance programme, the implementation of a working capital and refinancing facility for corporate clients, efforts to ensure the viability of critical infrastructure projects where commercial funding has fallen away, and the significant expansion of grant-financed assistance with the help of donors and the new Shareholder Special Fund. Further initiatives are under consideration. The implementation of the Bank's crisis response is actively monitored and reported to the Board.

However, the primary focus of this paper is on the recovery period, following the immediate "firefighting" phase of the crisis. The course of the crisis is difficult to predict. Nevertheless, financial sector disruption, caused by the retreat of commercial finance as well as by asset deterioration, is likely to remain a central concern during 2009 and possibly 2010. Furthermore, given the global pressure to reduce leverage in financial systems, it must be assumed that it will be many more years – if at all – before cross-border financial flows return to the levels experienced in the first half of the decade. The period 2010-2015 is likely to be dominated by efforts to revitalize investment and economic activity in the region within this harsher environment – precarious stability, scarcer capital and almost certainly, difficult social conditions.

It is the purpose of this note to examine how the Bank might best position itself to support the countries of operations during the period of revitalization and recovery. The note argues that in order to deliver a valuable contribution, in line with its particular attributes as a tool of public policy, the Bank must incorporate the lessons of transition and of crisis – especially an even stronger focus on the quality of institutions – in its approach, and that it should further develop its core competencies. In so doing, the note

seeks to provide elements for a renewed strategic guidance by shareholders for the coming years, which would give the Bank a strong foundation to play its part in the region's recovery.

1. EBRD CRISIS RESPONSE PROGRAMME: BRIEF OVERVIEW

Emerging Europe and Central Asia are being hit harder by the global crisis than other regions. Following buoyant growth in recent years, the EBRD is now projecting regional output to contract in 2009. Some countries are still expected to grow, but others are likely to see dramatic declines. In response to the crisis, the EBRD has both scaled up and refocused its project targets. The 2009 investment target of €7bn represents a 33 percent increase relative to commitments in 2008. The response is focused on sectors critically affected by the crisis and builds on the private sector competency of the Bank. Specific operational initiatives that have been launched so far include:[1]

- *Bank recapitalisation and liquidity support*, particularly for systemically important banks, aimed ultimately at ensuring a continued flow of funding to the real economy, especially SMEs. In this regard, a "Joint IFI Action Plan" was launched in February by EBRD, EIB and IFC, for an amount of up to €25 billion over two years, directed at the main international banking groups active in the region. The action plan seeks to address the recapitalization and refinancing needs of banking networks in a coordinated and equitable manner, in collaboration with both home and host country authorities and the IMF.
- An expansion of the *Trade Facilitation Programme* (to a maximum of €1.5bn, up from €490mn outstanding in 2008), which guarantees trade transactions and also provides short-term liquidity via selected banks to local exporters, importers and distributors.
- Critical *energy and infrastructure financing*, directed at a number of large projects (in excess of €100mn) from which commercial funding has been withdrawn; systematic efforts are being made to co-finance these projects with other IFIs, in particular the EIB.
- A *Corporate Support Facility,* which seeks to provide quick-disbursing financing to corporations to alleviate funding constraints arising from the deteriorating financial and operating environment. The facility will cover working capital needs, completion of capex investment already underway, capex with a short pay-back period such as energy efficiency investments, and balance sheet consolidation (where short term debt, no longer available due to the crisis, needs to be refinanced into longer term).

In addition, the EBRD is seeking to leverage its impact through initiatives outside the traditional toolbox. This includes, for example, *unfunded risk participations*, in which the EBRD shares credit risk with, but does not require financing from, cash-strapped banks whose financing it would normally complement through loan syndications. The Bank is also actively exploring how it can utilise its derivative market access in countries such as Hungary, Poland and Romania to provide systemically important

[1] A fuller description and update on implementation of the EBRD's crisis response, will be contained in a companion paper issued ahead of the Annual Meetings.

regional financial institutions with access to *FX risk management products*. The Bank would intermediate between local banks and international commercial banks - thereby eliminating these hedge banks' counterparty concerns.

2. TRANSITION: APPLYING THE LESSONS OF EXPERIENCE

2.1 20 years of transition

EBRD was established to facilitate transition to markets and democracy and to foster entrepreneurship in a part of the world where, for decades, individual economic and political rights were suppressed and citizens and businesses served only the state. The Bank's main purpose, therefore, was to encourage a process of decentralisation, demonopolisation and privatisation in its countries of operations mainly through its investments and associated policy dialogue. Transition was about reducing direct state intervention in the economy and establishing some basic market mechanisms: allowing prices to be determined by supply and demand; moving to private ownership of firms; reorientation of domestic and international trade; creating competition, increasing financial intermediation of savings to investment.

Twenty years of transition to markets and democracy has delivered vast improvements in political freedom, in efficiency of resource allocation, in economic performance and in general living standards. All but a handful of countries (in the former Yugoslovia and former Soviet Union) now have a GDP that well exceeds levels seen in 1989. A sizeable middle class has grown up around the region, creating a strong platform for further progressive reforms. The recent EBRD/World Bank Life in Transition Survey showed that across the region a large majority of people support democracy and markets over their alternatives. The EBRD Transition Indicator scores, published each year in the Transition Report, similarly show an impressive record of achievement in putting in place key reforms in markets and trade, financial institutions and infrastructure.

The Bank has contributed to this process by working alongside governments in its countries of operations, shareholders and project sponsors to create a thriving private sector, foster entrepreneurship and build market institutions. The Bank's mandate and development model, which most countries embraced, was an appropriate one for countries making the historic transition to democracy and a market-based economy.

Of course, the transition process is not yet completed in the region. Real challenges remain and the possibility of backsliding in the face of the current international financial crisis cannot be discounted. Most countries have completed or nearly completed first phase market enabling reforms (trade and foreign exchange liberalisation, price liberalisation and small scale privatisation), while comparatively less progress has been made in second-stage market deepening reforms (large scale privatisation and financial sector reforms) and third-stage market sustaining reforms (governance, competition and infrastructure). However, the distance from the reform frontier differs by region and by country.

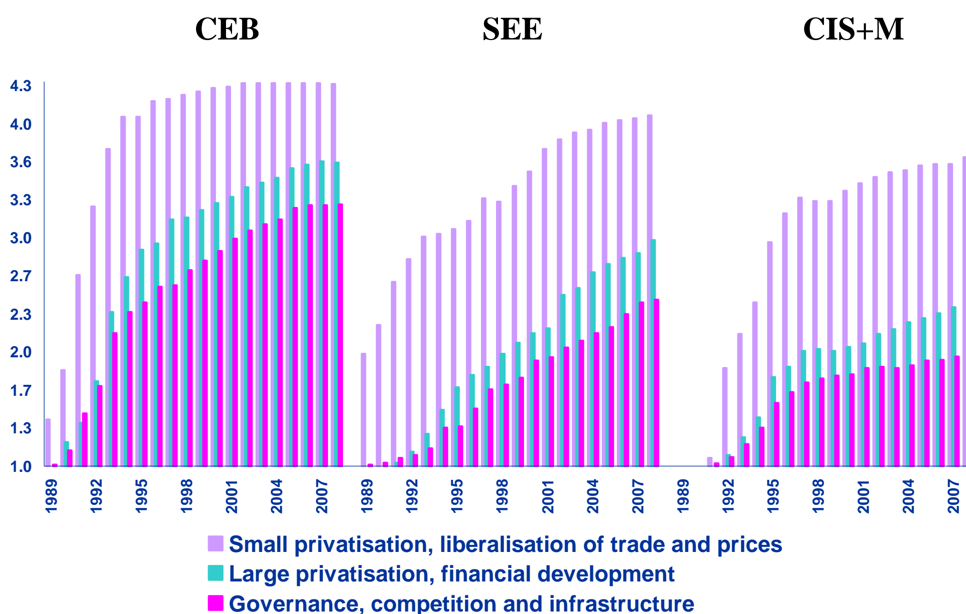
Transition achievements by region

Moving from a planned economy to modern market structures has gone further and faster in *central eastern Europe and the Baltics* than in any other region. First-phase, liberalising reforms were swiftly implemented in the early years of transition and most of second-stage reforms were carried out in the run-up to EU accession in 2004. CEB economies consequently have a strong market basis and a healthy and increasingly strong private sector. However, the unfolding global financial crisis has illustrated remaining weaknesses in the financial sector – some of which can also be found in more mature market economies – and transition gaps in infrastructure and capacity for product innovation remain.

A decade of conflict and political turbulence in *South-Eastern Europe* took its toll and much-needed economic reforms were delayed for most of the 1990s. However, over the past few years the transition process has accelerated and in recent years the SEE countries have been the fastest reformers of the region. Competitive pressure within the European Union provides an incentive to advance reforms in the new member states and candidate countries, particularly the third stage covering governance, competition policy and infrastructure. Throughout the region, there is a pressing need for substantial investment in the energy sector and transport, with greater involvement of the private sector.

Transition progress has been uneven in the countries of the *Commonwealth of Independent States and Mongolia* (CIS+M), and a large number of reforms remain unfinished. In Russia, the largest economy in the region, markets are broadly in place but much more remains to be done in the area of institutional reform, where progress has slowed in recent years due to high oil prices and weakening political resolve. The Ukraine and Kazakhstan share similar transition gaps. In the Caucasus, Armenia and Georgia have successfully implemented first-stage reforms and privatisation but third-phase reforms are substantially less advanced. For parts of Central Asia and Belarus the immediate hurdle is the first-phase reform of market liberalisation. Stronger government commitment is required to trigger these reforms. Throughout these economies, there is substantial scope for further energy efficiency gains. The ongoing tightening of international credit markets will make financial sector reform more urgent: in the absence of cheap and easy access to external finance, market reforms will be needed with a focus on quality, stability and higher governance standards.

Chart 1: Progress in transition by phases



2.2 Balancing state and markets

According to Article 1 of the 1991 Agreement Establishing the Bank, the purpose of the Bank is "to foster the transition towards open market-oriented economies and to promote private and entrepreneurial initiative in Central and Eastern European countries committed to and applying principles of multiparty democracy, pluralism and market economics".

What exactly constitutes a "market-oriented economy" is not specifically defined in the Agreement but the main methods to achieve that objective - decentralisation, demonopolisation and privatisation, as referred to in Article 11.2(ii) - suggest a limited role for the state in the ownership and running of the economy. In the early years of the Bank, the emphasis was therefore placed on reducing central ownership of and direct intervention in the economy, while at the same time building market mechanisms and private ownership.

The broad thrust of efforts in the early years was to achieve less state and more market. The debate was of course always more nuanced, and the complex picture that has emerged over 20 years underscores this:

- First, finding and reaching what one might call the optimal role of the state is not just a matter of reducing state interference and control but involves reducing or eliminating certain state activities while developing others. That is, transition is not just about the *size* of the state's footprint in the economy, but about where and how the state treads: that is, *what* the state does to affect economic outcomes, and *how* it attempts to do so.

- Second, the quality dimension of transition is essential. This applies, first, to state or government institutions. State institutions with similar objectives – for example, enforcing laws, collecting taxes, or supervising the financial sector – can have vastly different impact, both with respect to their effectiveness (for example, whether laws are actually enforced and taxes are collected) and with respect to the "collateral burdens" that state activities impose on the private sector. The quality dimension is equally important with respect to non-state institutions. Markets do not function well if they are not competitive and if there are barriers to entry. Corporations do not function well if corporate governance is poor and minority investors are not protected. Institutions of this kind may need to be defined broadly to include values and attitudes, since unwritten rules – for example, with respect to what constitutes acceptable behaviour within a firm, or in the political arena, or on the side of government officials – may be as important in practice as explicit rules.

Importantly, the state and private institutions generally are not substitutes. Indeed, in well-balanced market economies they should be complements. Sophisticated markets are much more likely to require sophisticated regulation to support them. Furthermore, some productive activities can be made more efficient with the participation of both state and private institutions (private-public partnerships) but doing so successfully will generally be very demanding on both sides.

In sum, transition is about building markets and the private sector, but it is also about redefining the state as opposed to minimising it, and it should be about improving the quality of both state and private institutions and ensuring that they work well together.

Defining transition in this manner implies the challenge of developing a clear understanding of the role of the state. With almost 20 years of transition experience at the sectoral level, there is a solid body of lessons that can be drawn upon.[2] But the ideal division of labour between state and markets may differ. For example, very weak capacity of the state in the provision of certain public goods could argue for a greater private sector role. Conversely, lack of competition could argue for a temporarily broader role of the state in certain markets. This raises tricky questions regarding the sequencing of reforms.

The counterpart of these challenges is that such a framework provides a much better compass for transition particularly in more advanced transition countries, where markets have already been created and the original role of the state has already been transformed, because it spells out in much more detail what the structural challenges may be beyond these basic reforms. But such a framework can also be helpful in early transition countries, in particular by flagging, and hence helping to avoid, potential pitfalls.

[2] A good place to take up the challenge are the EBRD "sector strategies", which outline transition objectives by sector and how the Bank proposes to contribute to these objectives.

Of particular relevance to early transition countries is the observation that reforms or projects that enhance the role of markets do not necessarily constitute a move towards transition goals if they result in poorly functioning markets. This may be the case, for example, when a privatisation is executed poorly, or undertaken in the absence of supporting institutional reforms (for example, reforms that safeguard competition, or create the basis for good corporate governance). In some cases, the best way to further transition may be purely through the improvement of existing institutions, leaving the relative roles of the state and the market unchanged. And in yet other cases, advancing transition may even mean a bigger role for the state in a particular area or sector, if the most effective solution envisages a particular state function which was undeveloped to begin with: for example, in the area of financial or environmental regulation and infrastructure.

2.3 Impact of the global crisis

The importance of quality, the role of institutions and the challenge of finding the right balance between state and markets had been recognised well before the crisis hit the region. But the message was blunted by overabundant liquidity which was forgiving of weaknesses and policy mistakes.

While the crisis has originated outside the transition region, it has laid bare a number of "home-grown" vulnerabilities. The rapid global integration of the region created enormous opportunities but also allowed imbalances to build and global shocks to reverberate in the region. While some of these issues are not exclusive to the transition region – especially in the financial sector – they combine with remaining transition gaps to leave the region strongly exposed to the global downturn. Experiences, of course, differ across countries, and many are yet to fully run their course. Given differences in macroeconomic management, in economic structure and in the progress of structural reforms (as described in section 2.1) some countries will inevitably be more vulnerable than others. Nevertheless, there are several prominent features:

- In a number of countries, the phenomenal growth of banking systems had moved well ahead of local deposit-raising capacity, as well as of the quality of risk management and systemic regulation.
- Domestic capital markets remained too shallow to supply the term-funding capabilities needed to match the region's investment drive – hence a dangerous reliance on external funding sources and exposure to exchange rate volatility.
- Investors chasing yield had disregarded immature corporate governance and weaknesses in the legal and institutional framework.
- The growth model in many countries and sectors was predicated on limitless natural resources, a legacy of central planning that has aggravated stress on the balance of payments, weighed down on corporate competitiveness, and of course contributed to environmental degradation and climate change.

- In some countries industrial development during the transition did not make full use of the region's human capital - which also shrank through emigration - leaving them insufficiently diversified, with a low-skill manufacturing sector forced to compete with far more labour-abundant developing economies, and less flexible in adapting to sector-specific shocks (in others, though, the growth of labour productivity has been remarkable).
- In infrastructure and utilities, the region's enormous rehabilitation and investment needs have created bottlenecks, while institutional frameworks capable of attracting complementary private funding and expertise in a new environment of capital scarcity are largely missing or untested.

But the most important impact of the crisis on the transition process may be political, and its direction remains unclear. Questions about the market and globalisation are being asked by politicians, business people and ordinary citizens across the globe, not just in the transition region. The fact that the crisis started in the mature market economies and spread into emerging markets, rather than the other way around, may erode confidence in the model that the transition countries have been encouraged to follow for the past 20 years. Unfettered markets are seen as the problem rather than the solution. Foreign bank penetration into the transition countries may be viewed as a source of contagion rather than stability. The state could be looked to as a saviour rather than a burden by struggling financial institutions and large corporations.

Most transition countries are unlikely to be pushed off the path that led to market-oriented democracy. For these countries, only the application of these principles may be altered at the margins – for example, on financial market regulation – while the principles themselves are likely to remain firmly in place. In other countries, the crisis may have a more profound impact. It may give new momentum to a trend of increased state interventionism that was already underway mainly for political rather than economic reasons. Re-nationalisation, state direction of economic activity and creation of state champions are processes that have received a boost from the crisis, and in ways that may not follow the careful logic of institutional quality and public-private complementarity laid out in the previous section. It may take some time to reverse these processes and shift attention once again to the benefits of the market, strengthened by a competent state, as the most efficient way to allocate resources.

2.3 The short- and medium-term transition agenda

The previous sections have reviewed how experience and economic research have helped shape our understanding of transition. Going forward, the emphasis on quality – private and state – is perhaps the most fundamental challenge for transition.

However, the most pressing concern is of course the current crisis, which is spreading to all countries and to all segments of the region's economies. In the near term, crisis response calls for financial lifelines as well as for measures to sustain trade and aggregate demand. The EBRD has developed a range of specific crisis response activities to support the region in these measures; their rationale, scope and implementation are set out elsewhere. But while the temptation may be strong to give

structural considerations a backseat in these efforts, it is nevertheless crucial that policymakers – and certainly the Bank – fully incorporate the lessons learned about the factors that have made many of the region's economies especially vulnerable to external shocks.

As argued above, there is a strong convergence between these risk factors, a clear understanding of the role of the state and the medium-term quality challenge. In stabilising financial systems, the focus must be on robust balance sheet structures, risk management and institutional and systemic governance – in addition to addressing funding problems. In supporting municipal or energy utilities, the key will be to design sustainable revenue models that address affordability concerns while distributing risks and responsibilities between public and private sectors in ways that are perceived to be transparent and fair. And quality governance as well as the avoidance of waste (of energy and other resources) will be crucial to ensuring corporate competitiveness and renewed access to credit in a more demanding environment.

Beyond the immediate crisis response the CRR4 period should be dominated by efforts not only to intensify the quality agenda but also to deepen the fabric of the region's market economies. Adopting the perspective of the Bank's shareholders, continued efforts to firmly anchor pluralism and democracy remain very much part of this agenda in the EBRD region, both at local level and national level. Similarly, the fight against corruption and its corrosive effects not only on investment but on the social acceptance of the market economy will remain a central concern.

Financial sector

The immediate priority in this sector is to ensure stability and the resumption of normal conditions of financing to the real economy, especially smaller enterprises. This may often require the recapitalisation and funding of those banks that have a viable business model, including with government involvement. In light of resource and administrative capacity constraints interventions will have to be selective. An important consideration will be to structure government involvement so that it respects commercial decision-making (despite inevitable political pressures to direct lending) and does not become entrenched. The crisis is also an opportunity that should be seized in order to promote the further restructuring and consolidation of banking sectors, which remain fragmented in some countries. Given the strong presence of foreign banks in the region, a further immediate concern is to counter possible negative spillovers from retrenchment at parent banks, some of which may be the inadvertent consequence of the design of rescue packages in the home countries. This issue is developed in greater detail in recent Board papers.

In the medium-term, efforts must focus on further promoting solid prudential and supervisory frameworks capable of preventing a recurrence of unsustainable funding and lending patterns, including crucially the issue of cross-border regulation. This is a challenge not unlike that faced by the mature market economies, and reform will benefit from mutual learning and cooperation. The regulatory framework will need to be complemented by solid risk management systems and practices in the banks themselves,

especially with regard to exposure to the wholesale market and foreign currency liabilities. Broadly, the banks' growth strategy will have to rely more on domestic than foreign resource mobilisation, accepting the limits to balance sheet growth that this will inevitably entail.

However, the region has significant investment needs, and there remains a dearth of domestic resources on appropriate terms and tenors. The "quality" agenda should be supplemented by more systematic efforts at deepening capital markets than has hitherto been the case. Despite years of aspirational rhetoric, the development of on-shore savings and investment vehicles, including equity funds and pension and life insurance, continues to be hampered by inconsistent and incomplete regulation and tax legislation. Progress in these areas would support the stability of the financial sector as a whole.

Corporate sector

The immediate challenge in the corporate sector, apart from efforts to stimulate demand, is to ensure adequate access to working capital and trade finance through the banking system. A further threat, however, is protectionism. Protectionist action remains limited thus far, but can be an overwhelming temptation in the face of political pressures to counter job-losses (and bad examples from abroad). Protectionism can turn a difficult economic situation disastrous, and should be firmly resisted.

The medium-term agenda in the corporate sector covers a broad spectrum. In line with the overarching focus on the quality of markets and institutions a priority must be to encourage competition and reduce market concentration. In the presence of excessive market power markets do not work efficiently to the benefit of society; monopolies undermine the legitimacy of the market economy. Corporate corruption and weaknesses in governance – e.g., minority shareholder and worker protections, transparency – can have similar effects, and hurt competitiveness and global integration. While the relevant legal provisions have often been enacted in the region, policy over the coming years will need to focus far more strongly on strengthening enforcement mechanisms (competition authorities and bodies that investigate, adjudicate and penalise misconduct).

At the same time, the quality agenda will need to be supplemented by continuing efforts to deepen the region's market economies. Reforms should be directed at ensuring easier market entry and orderly exit and creating a business environment that encourages competition and economic diversification; at stimulating innovation and increasing productivity at the firm level; and at nurturing entrepreneurship. Innovation and diversification are closely associated with a country's human capital and are often seen as a key to sustaining long-term economic growth. Countries in the transition region had some advantages in this area – a well-educated population and infrastructure to support knowledge-based industries – which they have not managed sufficiently to convert into globally successful innovation (and which have been suffering from underinvestment in education). The main problems appear to be in weaknesses in the markets for entrepreneurship and risk capital, in the institutional framework (including intellectual property rights protection and policies that foster competition) and in connecting universities and business.

Another area that should receive continued attention is the development of integrated production chains. Backward linkages from globally competitive producers to suppliers are among the most powerful channels of SME development, of diversification and of the transmission of technological, managerial and quality standards. The automotive sector is often at the core of such production systems in the more advanced market economies. Agribusiness is another industry in which the region offers significant potential. The comprehensive development of the food chain from primary agriculture to storage, transport and value added manufacturing could be one of the region's true competitive advantages in an era of growing scarcity, but is still largely missing.

Energy security and climate change

More than in other sectors, the transition agenda for energy is driven by political developments and commitments. Nevertheless, as discussed previously there are strong links both to overcoming some of the macroeconomic vulnerabilities of the region's economies, and to building globally competitive industries. In contrast to other parts of the world, existing shortcomings – especially the wasteful use of energy – are rooted in the region's centrally planned past, and overcoming this legacy is therefore intrinsically part of the transition process. There is an important quality agenda, relating to the governance and transparency of the energy market, the institutional and policy framework for market development and pricing, as well as corporate conduct.

Thus, speeding up the shift towards an energy efficient/low carbon economy has become a key priority, with a further sense of urgency added by the EU's December 2007 agreement on targets for energy efficiency and renewables. It is clear that even though the financial crisis may temporarily divert political attention elsewhere, this priority will continue to grow in relative importance.

Energy security is equally becoming an important agenda. It aims at the diversification of energy sources, suppliers and transport systems, in order to avoid supply disruptions or the consequences of adverse market movements, and there are linkages with energy efficiency and the development of renewable energy sources. A number of high profile trans-European projects would help to increase energy security and integrate more member states into the European electricity grid.

Dependence on nuclear generation is high in the EBRD region and will not diminish despite the closure of the older high risk reactors, notably in the EU. Russia and other countries have extended the operation of their older reactors and will continue operating them until the replacement nuclear generating capacity is in place. Ukraine, Bulgaria, Lithuania and the Slovak Republic have all taken decisions to build new nuclear plants and some other countries are considering it. Consequently nuclear safety of the operating plants and the safety and security of spent nuclear fuel and waste remain crucially important for the region. These are also prerequisites for the success/viability of the nuclear sector in general.

Infrastructure

The crisis is affecting the infrastructure and utilities sectors primarily on the funding side. As private term funding declines, the immediate challenge is to ensure availability of public and IFI financial support for critical projects. Beyond this immediate priority, however, the region faces a continuing and massive need to replace its ageing infrastructure (including energy).

The fast growth of recent years has stretched existing capacity. Tariff reforms have revealed the inefficiency of the inherited capital stock in energy and municipal services. A transport network still largely patterned on the needs of the COMECON is at odds with emerging global trade patterns. As a result, infrastructure investment has begun to accelerate throughout the region, and despite inevitable setbacks during the crisis will need to grow still further.

Given the scarcity of public funds, it is more important than ever to supplement public budgets with private funding and to clarify the legal framework for partnerships between the public and the private sector aiming at carrying out a mixed mode of financing. These are among the least advanced dimensions of the transition process. Governments must "get it right"—in terms of consultations, affordability, the allocation of risks between the public and private sectors—in order to ensure quality services and mitigate the risks of a political backlash. Where pure public sector approaches are pursued, there will still be the need for efficiency, a clear revenue model, transparent procurement rules and the outsourcing of peripheral activities. These are considerable challenges, especially at the municipal level.

At the same time, there is a need to act and put in place policy and regulatory conditions and incentives that are conducive to environmental and climate change objectives. Markets themselves struggle to achieve efficient outcomes in these areas, given the presence of significant externalities. Successful transition requires frameworks that monetise and internalise the costs of environmental damage, and projects that help achieve these objectives contribute directly to transition towards well-functioning and sustainable market economies. Price reform should be the core of any such strategy but, especially in the CIS, incentives and regulation remain weak.

Further transition challenges

The above has focused on areas in which the EBRD has had an active operational engagement. However, the agenda facing governments over the coming years is of course far broader. Although most countries in the region have seen considerable progress in creating markets and overcoming the legacy of communism and the post-transition recession, some sectors are still sorely neglected. Health, education, housing and primary agriculture have received very little investment and seen scant structural reform since the transition began. The consequences of this degree of neglect are evident in declining quantitative indicators on health and welfare, on educational achievement and on lagging productivity of farmland in the region. They are also evident in household surveys on the impact of transition on people, including the

EBRD/World Bank Life in Transition Survey. People in the region see the decline in health and education standards as amongst the most acute problems that require additional investment. Removing obstacles to transition in sectors such as health and education may be as important for the future of the region as deepening existing market structures in the financial, corporate or infrastructure sectors.

BOX 2: TRANSITION – APPLYING THE LESSONS OF EXPERIENCE

20 years of experience since the fall of the Berlin Wall, and the current crisis, have refined our understanding of transition:

- transition is not just about the *size* of the state's footprint in the economy, but about *what* the state does to affect economic outcomes, and *how* it attempts to do so;
- the quality of institutions – state and private – is a key ingredient in successful transition;
- weakness in the institutional framework, in the financial, corporate and infrastructure sectors, was exacerbated by fast growth and is contributing to the depth of the crisis.

Reflecting the evolution of the region and the impact of the crisis, the priorities for the coming period include:

- transition and the deepening of democracy with a growing emphasis on qualitative dimensions of the transition such as institutional and environmental sustainability;
- 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.

3. EBRD COMPARATIVE ADVANTAGE

The Bank has a number of attributes which – combined – distinguish it from other institutions and instruments of public policy. Some of these attributes are inherent in the Bank's charter while others have been crafted over time. As shareholders consider how best to address the short- and medium term transition challenges for the region, these attributes are a source of *comparative advantage* of the Bank, enabling shareholders to achieve certain goals more effectively and at a lower cost to the public purse 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. These comparative advantages are summarised below in terms of mandate, institutional and operational features.

Mandate features

- The **EBRD transition mandate** is a very special feature. In practice, it implies that EBRD makes its participation in projects conditional on various changes which enable to achieve progress towards open market-oriented economies. It is very important for shareholders as it ensures that their capital contribution supports actual systemic changes and progress in the region, and reflects the particular value of the EBRD. What might be seen as an operational limitation is also a strength in that it publicises EBRD confidence and may be regarded as a seal of approval. This implies the need for client relationships to 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 that optimal leverage of public funds is being sought. It is also a source of strength at the operational level as it creates a positive positioning vis-à-vis market players, complementing rather than competing with, the private sector.

Institutional features

- **Global institutional shareholding**. The Bank's institutional shareholding is global, which gives it widespread support as well as neutrality and independence. This is appreciated by its clients (countries and private sector entities). The Bank is not the instrument of a particular shareholder or group of shareholders, but serves all shareholders and is perceived as such.

- **Regional focus**. The Bank is specialised in one geographical area: a set of countries, which have some common characteristics, having all been command economies in the past except for Turkey. It is a focused remit which has been reinforced through local presence on the ground. In those countries, the Bank has accumulated significant sector experience sometimes with a very large number of operations, for instance in the financial sector, in agribusiness and municipal infrastructure or in early transition countries. This has enabled the Bank to acquire a deep knowledge of the countries in which it operates, which in turn enables it to be in a position to protect investors against political or administrative interference, and to concretely facilitate investments. No other institution has developed this combination of country/sector expertise in the region, an attribute appreciated in particular by foreign investors.

Operational features

- **Project focus**. The Bank is a project bank, with a strong transactional culture. It has a concrete, tangible activity leading to a 'real economy' impact which is visible (for instance the impact of an improvement of water quality or urban transport on the life of ordinary citizens). It is engaged in the micro, rather than macro economic area and does not carry out policy or programme lending.

- **Private sector focus**. The Bank is a hybrid institution combining a private sector focus with a public mandate and governance structure. This allows the Bank to be strategic in its purpose, pursuing public shareholder priorities while having a dynamic business driven approach combined with discipline and governance. At the same time, it allows the Bank to support organisational forms on the continuum from state to private that are best suited to the particular purpose or that represent steps along that continuum, including corporatisation of entities in the municipal sector.

- **Risk-taking capacity**. The Bank has a proven 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 made possible by the investment technology and experience built by the Bank 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.

- **Commitment to high quality standards**. The Bank adheres to high standards of quality (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 One World Trust). In particular, the Bank has built credibility in environmental compliance, and an image of neutrality. The EBRD involvement is sometimes sought by clients as a seal of approval.

- **Public-private mediation capacity**. The Bank has developed over time an ability to mediate 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. This is particularly useful in infrastructure and energy activities. However, the Bank should not be complacent about this attribute. There is sometimes a sentiment that the Bank's ability to undertake policy dialogue and obtain results is overstated. At the same time it is acknowledged that the current economic situation could substantially increase the Bank's ability to achieve more results in policy dialogue. The Bank's strength is more in addressing generic legal and regulatory issues that arise from specific project experience than dialogue at general level. This however requires appropriate guidelines to handle, in a principled manner, potential conflicts where the Bank seeks at once to advise the Government and support a project proposed by a potential or existing private sector client.

The objective over the CRR4 period must be to combine these comparative advantages of the Bank in ways that effectively address crisis response, economic recovery and the broader transition agenda. Though relatively large as an investor – the single largest consistent foreign source of project finance in the region – the Bank is nevertheless small if measured against the overall investment challenge in the region. Since its inception, the Bank has contributed finance equivalent to between 1 and 3 percent of fixed capital formation, depending on the sub-region.[3] The Bank should therefore deploy its comparative advantages in a targeted manner, structured around the further development of a set of core competencies. This does not necessarily imply a narrow sectoral focus, since some of the Bank's attributes and competencies are "horizontal" while others can be applied "vertically" to particular purposes *within* sectors.

Successful development of a set of core competencies rooted in its comparative advantages would allow the Bank to further strengthen its "brand" over the CRR4 period – an identity instantly recognised by shareholders as a valuable tool in the pursuit of key public policy objectives. Before expanding on the Bank's core competencies in the next section, however, it is useful to examine how the Bank's existing comparative advantages might accommodate a strengthened focus on quality and institutions.

Institutional quality objectives have been "grafted" on to the Bank's financing function. The Bank has used a combination of sponsor / project selection, persuasion, technical assistance and the leverage of its funds (project conditionality) to achieve quality objectives such as better governance structures, environmental conduct or risk management. On occasion, this approach has been complemented by policy dialogue, especially in the regulated sectors. While broadly successful, as reflected in transition impact scores, the lessons learned from the transition experience and the crisis (section 2) suggest the need to make an even more systematic effort to help shape not only project entities, but the institutional context in which they operate.

To do this effectively, the Bank could seek to leverage its position as a major financial investor in its countries of operations to achieve qualitative and systemic change. The challenge is to maintain its strength and focus as a transaction-oriented *bank* while at the same time developing its technical assistance/advisory and policy dialogue capacity. Donor support and the new opportunities offered by the Shareholder Special Fund would be essential ingredients in this approach. Thought would need to be given to ways of ensuring that the funding of TC is more systematic and predictable, as well as to possible organisational implications, in particular to effective ways of involving non-banking departments in TC and policy dialogue.

[3] At the upper end of that range in the early and intermediate transition countries, and at the lower end in central Europe and Russia.

- First, on technical cooperation, the Bank might consider giving a strong boost to stand-alone TC projects that seek to strengthen regulatory or institutional capacity at the central, regional or municipal level. The Bank's legal transition programme has already demonstrated how this could be done for certain aspects of regulation (telecoms, securities markets) market-supporting laws (concessions, insolvency) and judicial reform (training judges). The Bank's work on power sector reform in Russia and Ukraine and the recent TC project to support financial sector reform in Ukraine are other examples of how the Bank can use its project and sector knowledge to promote regulatory change through technical assistance. This could be used as a model for other areas of reform where the Bank can add value, most notably the sustainable energy initiative. However, the Bank's leverage derives from the financing of projects, and even stand-alone TC and policy dialogue should remain broadly linked to its investment programme. Furthermore, the Bank should of course not duplicate or substitute the work of other IFIs.

- Second, on policy dialogue, the Bank would need to dedicate significant additional resources to conducting sustained dialogue with relevant country authorities. Currently, policy dialogue tends to be fragmented because many teams do not have the means or the incentives to engage seriously in the type of dialogue that would lead to regulatory or institutional change. Greater coordination would be needed across teams within the Bank, as well as with other IFIs and donors. IFI coordination with this purpose is discussed further in section 5. It is important that policy dialogue initiatives remain firmly linked to existing or potential projects, as this is where EBRD can have the most leverage.

- Third, on projects, in justified cases the emphasis could shift away from measuring transition incrementally through each transaction to identifying more "transition programmes" that seek to bring about systemic change at the sectoral level by creating a critical mass of projects over time. Early examples of such an approach include water and environmental projects in Romania.

The application of such a strategy would not privilege one sector over another (financial sector vs. energy/infrastructure vs. corporate), but rather would target certain horizontal objectives – primarily effective regulation, competition, economic diversification, innovation, improved public service delivery and energy efficiency.

BOX 3: EBRD COMPARATIVE ADVANTAGE

The EBRD has a specific set of comparative advantages relative to the market and other IFIs which underpin its value to shareholders. These include:

- its focused transition mandate which leverages its investments to achieve systemic changes and progress in the region;
- respect of the additionality test to ensure the most efficient use of public funds;
- a global shareholder base which provides the EBRD with widespread support as well as neutrality and independence;
- focused knowledge of the region with a significant operational experience in a broad range of countries and sectors;
- a transaction-based approach with a concrete and tangible 'real economy' impact;
- proven capacity to take debt and equity risks and a track record in implementing high quality standards;
- a hybrid approach combining a private sector focus with a public mandate and governance structure; and therefore,
- an ability to mediate between the public and private sectors, based on the combination of public sector credibility and private sector management culture.

The challenge over 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 Bank should deploy its comparative advantages in a targeted manner, structured around the further development of core competencies;
- a set of core competencies would define the Bank's value to shareholders as a tool in the pursuit of specific public policy objectives;
- 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; however,
- its transaction focus must remain the Bank's defining feature.

4. EBRD CORE COMPETENCIES

The Bank has, over the years, developed a number of core competencies to address strategic objectives – both **vertical**, i.e., sector-specific, and cross-cutting or **horizontal**. Some of these can be further deepened and refocused in order to respond most effectively to the challenges posed by crisis and recovery over the coming years. In addition, new competencies might be developed to address emerging transition challenges and the priorities of shareholders.

In reviewing the Bank's core competencies in the following, it should be borne in mind that the Bank's operational effectiveness also relies on **functional** competencies (such as the commercial loan syndication function and donor fund mobilisation) as well as **control functions** which include transition impact analysis, credit analysis, sound legal structuring and environmental due diligence. In fact, these aspects of the Bank's work are a key contributor to its comparative advantages as set out in the previous section.

This section identifies Bank core competencies in supporting specific quality objectives in the following areas:

- a financial sector competency supporting the development of solid and well-governed banks and capital markets through direct investments;
- a corporate sector competency supporting smaller businesses, high standards of business conduct, diversification and value-added creation;
- an energy sector competency supporting directly well-regulated energy supply and security, and leveraging energy efficiency across economic sectors; and
- an infrastructure competency supporting local governments and developing efficient transport systems, involving both the public and private sectors.

The identification of certain core competencies does not imply that other areas of activity should be neglected over the coming strategy period. Nevertheless, these core competencies link the Bank's attributes and comparative advantages most effectively to the broader transition priorities for the region, and their further development should therefore receive added emphasis.

New priorities for the Bank may emerge during the CRR4 period, and the Bank should have the flexibility to further adapt and develop its competencies. One area that has been mentioned is the scope to build on the Bank's existing expertise in developing projects with an environmental and a health&safety focus. While the needs in these areas are substantial, the Bank's approach must reflect its comparative advantages as an investor- and transition-focused institution. Strategic guidance is beginning to emerge, including the pursuit of programmatic approaches that combine a critical mass of investments with systematic efforts to help upgrade regulatory standards and business practices.

The consequences of the crisis, and especially the renewed prominence of the state in economic activity, are likely to condition the Bank's work during the strategy period across all core competencies. In selecting and designing projects, the Bank can position itself to work with its partners in the region to encourage the state to play an active role in ways that are consistent with market principles (state regulates and redistributes) and with commercial practices rather than distortionary. Through its operations, the Bank can select and design transactions to help prevent transition reversals – mainly in the financial sector, but selectively in other sectors as well. Through TC operations and policy dialogue, the Bank can try to use the crisis as an opportunity to reaffirm the importance of good governance and appropriate regulation.

4.1 Financial sector competency

The Bank has built up its experience in this sector by playing a broad and active role from the earliest stages of the transition. This has involved supporting the creation of the first private banks in a number of countries, the privatisation of state-owned banks, building up an equity funds industry focused on the region, developing new lines of business such as credit lines for SMEs or for energy efficiency and launching new products such as leasing and mortgage financing. Net cumulative business volume in

the FI sector exceeds €13.5 billion for a total project value of €26 billion. As at end 2008, the FI portfolio reached €7 billion for just over 700 projects. The Bank has actively used equity products, either through direct equity or through equity funds, in the development of its FI portfolio.

As discussed previously, the global financial crisis is revealing the fragility of the financial systems in the countries of operations. The region's financial sector, more acutely than those elsewhere, is currently not in a position to finance effectively the real economy, in particular SMEs. The Bank's Financial Sector Response Package to the crisis is substantially expanding FI activities and will absorb increasing resources for a period of time. In particular, the Bank will need to support its clients with a broad range of products, encourage better risk management systems and prudential regulation, and be at the forefront of IFI cooperation to buttress banking networks in the EBRD region, in order to help re-establish confidence in banks and financing of the real economy. The renewed presence of the state in the sector calls for a careful examination of its rules of engagement (and subsequent disengagement), a process in which the Bank can make a useful contribution. The Trade Facilitation Programme can play an even more important role at a time when trade flows are threatened by the lack of finance and/or confidence.

The present crisis in emerging markets has underlined the importance for clients of diversifying away from external sources of finance, particularly in foreign currencies. Also, excessive reliance on short term bank debt creates dangerous maturity mismatches on balance sheets. This points both to a requirement to offer loans in local currency, and to advance local capital markets so that they will ultimately be sustainable without IFI involvement. Local currency lending and funding, and the development of domestic capital markets, have become strategic issues in the transition process.

The Bank has already played an important role in this process in the transition region. Since the first EBRD local currency bond in 1994 in the Hungarian domestic market, the Bank has issued bonds in the currencies of six of its countries of operations. The EBRD has worked with local commercial banks and authorities to introduce or enhance money-market indices (such as the MOSPRIME in Russia) in order to improve the transparency of the domestic market, the consistency of loan pricing, develop greater liquidity as well as to lengthen the maturity of financing and thereby reduce maturity mismatches. The development of self-sustaining domestic capital markets requires a robust market infrastructure including effective settlement and clearing systems, as well as a transparent and comprehensive legal and regulatory framework, which the EBRD has worked with several of the Bank's countries of operations to reform. It should be mentioned, however, that long-term lending in local currency is still developing and is being challenged in certain countries (such as Russia) by unsustainable market circumstances. This product is important and needs to be developed as conditions permit.

As in other sectors, policy dialogue can have relevant systemic impact in this area and must remain linked to practical instruments and experience rather than theoretical considerations. Whereas many IFIs have a capital market development team that is separate from the business of issuing local currency bonds and/or managing local currency liquidity, these functions are fully integrated in the EBRD and closely coordinated with FI operations, giving the Bank practical knowledge of the obstacles to local currency lending and capital markets development.

Going forward, and building on its core competency in this area, the Bank should:

- support directly the liquidity, solvency and prudent reengagement of banks, focusing on those institutions – public and private – that have the potential to be stabilisers and consolidators in the coming restructuring of the sector;
- take a leading role in bringing together other IFIs, national authorities and regulators to try and ensure that local and cross-border banking networks continue supporting the real economy, in particular MSMEs and including local governments;
- help catalyse the return and wider availability of risk capital for small and medium-sized enterprises through private equity and venture funds;
- devote more resources to the development of local capital markets and local medium term financing sources through insurance companies, pension funds and capital market products; and
- use the Bank's expertise and credibility in the marketplace to engage in more broadly based policy dialogue, in particular on the regulatory aspects of bank consolidation and restructuring.

4.2 Corporate sector competency

The promotion of private corporate initiative and private projects with a focus on their quality, demonstration effect, governance and transparency is at the heart of EBRD's mandate.

Accordingly, the Bank's support for the corporate sector has over the years covered a broad range of sectors including agribusiness, general industries, property and tourism, and telecommunications. The Bank has used the full range of its financing instruments, including a significant share of equity, to build its corporate sector portfolio. Net cumulative business volume in the corporate sector exceeds €13.6 billion for a total project value of €49 billion. As at end 2008, the corporate sector portfolio reached €5.9 billion for 370 projects. The bulk of the corporate portfolio is in general industries and agribusiness.

The crisis reveals the precarious financial condition of many local companies, small and large, as well as the fragility of foreign investment flows. Moreover, the crisis exposes a lack of economic diversification in many countries of operations.

Although less "systemic" than in the financial sector, the Bank's presence in the corporate sector alongside a strategic investor, or a local company, remains significant from an economic point of view. While private investors, or their national financial institutions have often financed industrial projects on their own, a number of large investors have become clients of the Bank because of its ability to mediate between the public and the private sectors or offer unique products such as long term local currency. The Bank has also become increasingly relevant with local investors, a relevance reinforced by the current crisis.

While the Bank has developed an increasingly well-engrained approach to supporting SMEs, local companies and entrepreneurs, this competency must be further enhanced, in view of the significant impact on competition, employment and the diversity and vitality of market economies. The needs of this sector are compounded by the crisis which is hitting SME supplier chains hard and is having a major negative impact on employment. The Bank has established a track record through financial intermediaries (micro-lending and SME support), through special programmes such as the successful EU-supported SME Finance Facility in Central Europe (a good example of efficient leverage of public money), through special intermediaries such as the European Fund for South East Europe (EFSE) in the Western Balkans, through frameworks in ETC (DIF, DLF, MCFF), the Western Balkans (WBLEF), and other instruments (recent Facility for Medium-Sized Projects – FMSP).

Further efforts by the Bank could build on the recent equity framework (FMSP, mentioned above), to significantly boost its support to the "Mittelstand". The main obstacle will remain the existence of a cultural gap between entrepreneurs and EBRD in terms of the way of doing business. The TAM/BAS programme has achieved a lot in advising SMEs but could be mainstreamed further into the Bank's project work to achieve mutually reinforcing synergies. The Bank could also enhance its ability to mediate between the public sector and the private sector to promote entrepreneurship and help reduce regulatory and administrative burdens on businesses (e.g. by participating in efforts to reduce the time to create and register an enterprise), along the lines of the cooperation with the Foreign Advisory Councils in Kazakhstan, Romania and some ETC countries. And it could develop a more systematic approach to enhancing competition both through project selection and through technical assistance for and policy dialogue with the relevant authorities.

Beyond continuing to support the real economy through SME development and investments in the corporate sector to propagate high standards of business conduct and diversify the economic base of the countries of operations, the Bank could examine further evolving its competency in this area by addressing the following topics:

- Considering the importance of developing well diversified economies, the Bank must be more effective in developing its operations in the **manufacturing sector** (general industries). This requires a better leverage of the expertise which has been built in automotive, building materials, paper and wood products, and metals. The current organisation results in a limited clustering effect and a lack of critical mass, particularly for smaller countries.

- An important element of economic competitiveness and resilience is a country's capacity to innovate and to build a **knowledge-based economy.** The formation of knowledge-based economies is an essential part of the transition process as it involves making full use of the region's human capital potential, relatively neglected thus far by the markets. It would also contribute to building diversified and sustainable economies. This topic cannot be easily condensed into distinct industrial sectors. As in the case of energy efficiency, in order to make a difference the Bank would design a product line that bankers can use and a complementary capacity to engage in policy dialogue on the institutional and regulatory environment. Accordingly, rather than focusing on high tech areas, the Bank would identify opportunities across its operational activity to support innovation and knowledge/expertise.

- Transition has not yet happened in many ways in **agriculture**, even in the new EU member states (reform of land ownership, restructuring, privatisation of key agribusiness assets etc.). To address this area of slower transition progress, the Bank could invest along the agricultural value chain focussing on food quality and the further development of operations with significant backward linkages into primary agriculture.

4.3 Energy competency

Entering the third decade of transition in the EBRD region, it is clear that the energy sector and its impact on energy efficiency and energy security will be critically important elements of the upcoming phase of transition. The sector is characterised by ageing, inefficient assets that have suffered from years of underinvestment. This, combined with the region's high degree of energy intensity, threatens energy security, economic development and results in a disproportionate amount of carbon emissions and pollution. The sector is also undergoing restructuring and reform in an effort to introduce private finance, renewables and competitive disciplines. This will lead to greater efficiency but will also require increased tariffs. Successfully addressing and navigating these challenges, particularly during an economic downturn, will be difficult but critical to the region's transition, development and environmental outcomes.

The distinctive characteristics of the Bank's activity in the energy sector are an ability to combine intensive policy dialogue with country authorities, sector knowledge (both in-country and international) and promotion of the Bank's energy efficiency and environmental mandate. Net cumulative business volume in the energy sector reached €6 billion for a total project value of €29 billion. As at end 2008, the energy sector portfolio exceeded €3 billion for just over 100 projects, including energy efficiency projects in the power and natural resource sectors but excluding those in other sectors.

The Bank is well positioned to continue to play a leading transition role in the energy sector. Sector participants have come to rely upon the Bank's ability to combine policy dialogue with country authorities, sector knowledge and contacts (both in-country and international), its practical operational approach to energy efficiency and flexible financing instruments to meet the needs of each country and client. In addition, projects are vetted for environmental, health and safety and social (EHSS) impact and for ongoing monitoring of the implementation of the EHSS action plans. The Bank's leverage to achieve major impact in this sector has been affected by the very large amounts of money needed, and the credibility of the Bank's protection of oil/gas/mining investors from political interference in certain countries.

The Bank is able to further build its portfolio in this sector drawing on a number of core areas of strength, including:

- sustainable energy expertise in:
  - promoting energy efficiency and environmental improvements
  - investing in renewable energy
- supporting private investment and fostering privatisation;
- project finance and PPP structures; and
- role as a trusted policy advisor and 'honest broker'.

The Bank should respond nimbly to the short term impact of the crisis in this sector by adjusting investment plans in the region while focusing on continued longer term strategic goals. Therefore in the short and medium term, the Bank should target projects which maximise efficiency while more capital-intensive projects needed to meet additional demand are pushed back by changing economic realities, and continue to promote reform and market liberalisation to ensure the long-term fundamentals of the sector remain attractive.

Over the longer term, transition to a low carbon economy, energy security and private sector involvement and financing will be prevalent challenges. Addressing these issues will require early action. Therefore, concurrently, the Bank will continue to leverage its core competencies, focusing on sustainable energy, privatisations, regional integration and the strengthening of the investment climate for private sector involvement.

Energy Efficiency/Climate Change

The Bank's competency in energy efficiency and climate change has been established as a horizontal competency in support of operations not only in the energy sector but across all current sectors of activity including the industrial, financial and infrastructure sectors. The Bank started to focus on energy efficiency in 1994 reflecting the early realisation that energy intensity was a key issue in the transition of its region of operations. This has allowed it to develop a technical base and a range of operational experience over a decade.

With the launch of the Sustainable Energy Initiative (SEI) in 2006, this technical knowledge was significantly leveraged across the organisation allowing the Bank to scale up its energy efficiency activity in line with the strategic directions set in the CRR3 and in response to the call of the G8 at Gleneagles. The Bank's competency in energy efficiency financing has allowed it to contribute in a pragmatic and concrete manner to the international effort to scale up climate change mitigation financing. During the first phase of the SEI (2006-2008), the Bank committed close to €2.7 billion against an original objective of €1.5 billion. In 2008, SEI activity accounted for 20% of the Bank's annual activity.

The key elements of the Bank's strength and expertise in energy efficiency financing are:

- the effective **blending of financial and technical skills**. The major driver of operational results is the ability to translate technical energy savings into a sound banking business proposal;
- the progressive in-depth **mainstreaming** of this technical-financial combination across country and sector teams so that energy efficiency becomes an integral and internalised part of the business of each banking unit. This is achieved through the effective articulation between sharp technical and specialized skills in the Energy Efficiency and Climate Change (E2C2) team and the banking skills of country and sector teams; and
- the detailed articulation and **leverage of TC activities** to drive banking operations including product development/innovation, policy dialogue and institutional development.

Reflecting a sustained medium term strategic focus on energy efficiency and climate change and building on its core competence and results achieved to date, the Bank is launching Phase 2 of the SEI for the period 2009 to 2011. This includes the further scaling up of activities developed in Phase 1 of the SEI such as industrial, power sector and municipal infrastructure energy efficiency, renewable energy and carbon market development, and the definition of new activity areas involving, for example, buildings energy efficiency and climate change adaptation.

Nuclear safety

Experience in the management of multilateral nuclear safety funds over the past 15 years has helped develop a unique competency of the EBRD. The main elements of this competency include knowledge of nuclear safety, good understanding of the issues in the region of operations and rapport with recipient governments, ability to effectively communicate and co-operate with donor governments – many of whom have their own bilateral assistance programmes – and, ability to manage implementation of the projects which requires project management skills and experience in dealing with industrial partners. Complemented by the Bank's environmental, legal, procurement and financial expertise, this competency has been a key in achieving more than a ten-fold growth in nuclear safety grant commitments over the past ten years. This established competency is a solid basis to support any future financing of nuclear safety projects after the K2R4 is completed in 2009.

4.4 Infrastructure competency

A well functioning infrastructure network is a key requirement for growth, private sector development and improved quality of life. Consequently, the Bank has used a wide range of its financing instruments, to build its infrastructure sector portfolio. In doing so, the Bank pioneered the use of non-sovereign public lending as a means to mobilise additional capital and to promote decentralised infrastructure delivery in its countries of operations.

Net cumulative business volume in the infrastructure sector reached €8.5 billion for a total project value of €30 billion. Of these commitments, € 5.7 billion were for investments in Transport and $ 2.8 billion in the municipal infrastructure. As at end 2008, the infrastructure sector portfolio exceeded €5.5 billion for 330 projects, € 2 billion in the municipal infrastructure sector and €3.6 billion in Transportation. Around 30% of the Bank's funding in the infrastructure sector is directly relevant to EBRD's energy efficiency and climate change targets.

Support to local government

The municipal sector is a recognised strength of EBRD that reflects well the evolving understanding of transition and the Bank's comparative advantages. The Bank was among the first IFIs to recognise the advantages and transition benefits of lending for infrastructure investment on a sub-sovereign basis. Institutional strengthening of the public sector to make it transparent, accountable and more efficient continues to be a "brand" of the Bank, supporting both better public service delivery and elements of local democracy and decentralisation. As such, the Bank plays a crucial role to support a better public administration.

The Bank's emphasis on cost recovery and financial sustainability is a strategic advantage in addressing investment priorities in the context of weakening economic fundamentals. It is expected that providers of infrastructure and environmental services will continue to face political and social pressures for maintaining and improving service levels. This creates an opportunity for the Bank for broader engagement and increases the scope for transition impact of individual projects, or country-wide programmes, such as the one under-way already in Romania.

Key operational features supporting the notion of a better quality of state activity and a greater involvement of the private sector in the provision of public services are:

- *Promotion of commercialisation and efficiency of public service companies*: notably encouraging commercial discipline, tariff reform, and increased cost recovery, thus paving the way for private participation at a later stage when the regulatory, credit, and institutional risks have been reduced.

- *Mobilisation of donor money to address institutional or corporate development needs through Technical Co-operation:* TC projects will be incorporated in the structure of most municipal transactions to ensure that institutional (at city level) or corporate (at company level) capacity building (corporate governance, financial, operational and commercial capabilities) is achieved and the project achieves sustainable results.
- *Enhanced absorption of grant investment co-finance to manage affordability constraints (primarily ETC) or promote regional cohesion (EU)*: grant investment finance will be included in projects in Early Transition Countries or projects with a strong environmental component, where affordability constraints limit the amount of investment that can be financed on a commercial basis. In EU or pre-Accession countries the Bank will endeavour to facilitate absorption of EU Cohesion and Structural Funds through its implementation support capabilities.
- *Facilitation of the emergence of corporate players applying best practice standards as a tool to multiply the Bank's impact*: support to local private companies (where they emerge) or foreign strategic investors will allow the Bank to reach out to more and potentially smaller cities by making corporate funding (debt or equity) available under the condition that the Bank's standards (concession acquisition, governance, service, environment etc.) are followed.
- *Improve access to capital by widening co-financing with other institutions and lenders*: the Bank will actively seek to co-finance projects with other IFIs (notably EIB, NIB and others as appropriate), international banks or local banks to expand access of the municipal sector to long-term capital, with local currency funding being prioritised where possible.

Building on this competency, the Bank could explore under which conditions it might be able to work on pure public sector projects in support of strategic objectives such as energy efficiency and environment, (for example. energy efficiency in public buildings) and examine the possibility of undertaking pure environmental transactions in the municipal sector.

Transition oriented infrastructure

Investments in the transportation sector have spanned all transport sub-sectors at the national level, including roads, rail, airports and aviation, sea ports and shipping. More recently inter-modal and logistics has emerged as new a hybrid transport sub-sector.

The need for modernisation and development of transport infrastructure in the Bank's countries of operations remains substantial, following years of under-investment and limited maintenance of existing assets. Well developed transport networks are essential to support economic growth, including private sector development, and regional integration. While data on total investment needs for the transport sector across all of the Bank's countries of operations are not readily available, funding requirements are significant and generally exceed the capacity of state budgets and sovereign borrowing capabilities. The private sector therefore has an important role to play in speeding up the development of transport infrastructure and removing critical bottlenecks, while at the same time relieving the pressure on scarce public resources. The Bank has a catalytic role in mobilising private capital for this purpose.

The Bank's expertise in Public Private Partnerships and dialogue with state authorities has been instrumental in encouraging the development of mixed public-private financing on a sustainable basis. Many governments have turned to the Bank for advice on establishing appropriate legal and regulatory frameworks and developing tender processes in line with best international practice. This dialogue also provides a level of political comfort to the private sector. It seems that the model will survive the crisis, as this is one area where commercial banks are still willing to lend. Neverthelss, the potential for PPPs is likely to remain limited overall in view of their legal complexity, integrity concerns and political sensitivities.

In public infrastructure, the Bank is a small player compared to EIB and the World Bank. However, the sector offers scope for a division of labour with other IFIs in accordance with each institution's comparative advantages, with the Bank focusing on institutional strengthening and extensive implementation support and drawing on the combined weight of the IFIs in conducting policy dialogue. Engagement with the state and with state-owned entities also allows the Bank to identify commercial opportunities in infrastructure, where financing can be provided on a non-sovereign basis (e.g., rail freight) and activities which can be opened up to private sector participation (e.g., container operations and logistics).

The current market crisis and economic uncertainties to which it gives rise will have a number of implications for the way in which the Bank's business evolves in the transport sector in the near future. Demand for the Bank's financing is likely to increase in the face of liquidity constraints and scarcity of long term funding for investment from commercial sources. While this increase in demand potentially creates opportunities for the Bank to expand its activities and deepen its transition impact, it also requires a careful assessment of the scope and scale of investments and determined efforts to attract other financing partners. In particular, the Bank will need to:

- review with project sponsors downsizing and phasing of investments to reflect the new market realities and uncertainties;
- extend its co-operation with other IFIs and bi-lateral national development banks to allow the Bank to maintain a focused approach based on promoting transition and to bridge any co-financing gaps.

There will also be a need to increase policy dialogue in selected sectors and countries to encourage greater use of well structured PPP approaches and non-sovereign financing of commercially viable activities (e.g. airports and freight railway operations) to relieve pressure on scarce budgetary resources, which may be needed in other areas to stimulate the economies in our countries of operations.

In this regard, sovereign transport infrastructure projects, which are typically large in relation other investment activities in any given economy, may have an important role to play providing fiscal stimulus. The Bank will also need to be responsive to this need, provided the proposed investments are feasible and have high transition potential.

BOX 4: CORE COMPETENCIES

To address the transition challenges and priorities ahead, the Bank should build its operational strategy on the following core competencies:

- beyond its established financial sector competencies in areas such as bank equity, equity funds and non-bank financial institutions, the Bank will need to focus its capabilities on developing domestic capital markets and expand local currency lending activity;
- core competencies in the corporate sector should include an enhanced approach to SME development building on the broad range of instruments developed by the Bank to date, a more structured approach to supporting the manufacturing sector, the promotion of innovation in support of economic diversification and competitiveness, and the development of value chains in agriculture and agribusiness;
- leveraging its sector knowledge, policy dialogue capability and financing instruments to support the balanced development of the energy sector across the region;
- a strong energy efficiency competency mainstreamed across all sectors of activity in support of enhanced energy security, economic competitiveness and lower carbon emissions in the region of operations;
- specific skills in supporting sub-sovereign infrastructure financing solutions in the municipal and transport sectors and to develop mixed public-private infrastructure financing instruments combined with targeted policy dialogue involving legal and regulatory frameworks;
- within each core competency, the Bank should develop technical assistance and policy dialogue linked to its operational activity and – where appropriate – on a stand-alone basis in order to enhance the scope and depth of its transition impact; and
- the effective deployment of some of these competencies, particularly in early transition contexts or in innovative areas, will require the availability of funds for TC activities.

5. IFI COOPERATION

5.1 An opportunity for strengthened cooperation

While the Bank has been working well with a number of IFIs on both transactions and policy dialogue, the response to the crisis has brought to the fore the need for intensified and efficient cooperation among the IFIs so as to offer a leveraged answer to the new situation. Cooperation with other IFIs active in the EBRD region will be important in making the crisis response successful.

A better and more organised IFI cooperation is also called for regularly by their shareholders and Boards, as well as by clients and the donor community. It features in the latest declaration of the G-20, and is the essence of the harmonisation objective in the Paris Declaration on Aid Effectiveness (March 2005), recently reaffirmed by the Accra Agenda for Action (September 2008). According to the Paris Declaration, financiers should “implement common arrangements and simplify procedures” and strive towards complementarity and a “more effective division of labour”. The context of the crisis means that the problem of aid fragmentation addressed by these initiatives –

and the missed opportunities and distortions thus created – become even more relevant to the operations of IFIs.

Not least, increased co-operation is in EBRD's best interest, as the Bank's balance sheet is relatively small while the Bank has skills and products that other IFIs do not always have, in particular a strong implementation capability, the capacity to take commercial risks and an equity competency.

However the need for closer cooperation should be checked against other key objectives of the EBRD, notably its transition mandate, its additionality principle, its private sector focus and its aim to mobilise commercial co-financing. Any intensified cooperation should therefore be framed to ensure these fundamental aims of the Bank are not compromised.

In this context, IFI cooperation can provide an important instrument to pursue the medium term transition objectives of the Bank by:

- building on the policy and institutional expertise and dialogue of other IFIs such as the IMF and the World Bank in areas where the Bank does not have skills and resources due to its transaction-based approach;
- allowing the Bank to focus on its core competencies; and
- mobilising and leveraging IFI cofinancing for transition-oriented projects at a time when commercial cofinancing sources are scarce.

5.2 Cooperation experience

The Bank has developed over the years a broad range of cooperation:

- Cooperation with the **EU/EC** has been intense and multifaceted with transition in the accession countries being largely driven by the enlargement process. This cooperation involves many EC Directorates and corresponding Bank departments and involves significant funding support including both TC and investment grants. This cooperation reflects the convergence of objectives in certain areas such as the enhanced EU foreign policy interest in the Neighbourhood region and the active approach of the EU/EC to energy efficiency and climate change.

- While the **IMF** and **World Bank** have different mandates and objectives from those of the EBRD, there are a number of areas of common interest. The IMF and World Bank focus on macro, and in the case of the World Bank, on sector policies at government level relating to external stability in the case of the IMF and to economic development in the case of the World Bank. Cooperation with these institutions has intensified in the context of the response to the crisis in recognition of EBRD's specific local and private sector knowledge with real time cooperation in countries such as Hungary, Latvia, Serbia and Ukraine, and a joint assessment mission to Georgia.

- Cooperation with the **EIB** has been expanding including the development of institutionalised approaches such as the 2006 MoU for Eastern Europe, the Caucasus, Russia and Central Asia and the 2008 Accord for certain sectors of activity in Turkey. The focus of the EIB activity is different from that of the EBRD but can be complementary.

- The EBRD and the **IFC** have an overlapping focus on the private sector but operate with different criteria. In particular, IFC is not systematically concerned with transition impact. While the common private sector mandate has led in the past to competition for certain transactions, there has been very good cooperation in less advanced markets, such as Central Asia, and goodwill in the case of Turkey.

- The *modus operandi* of the **ADB** and EBRD are not comparable with the ADB focusing on development and poverty alleviation without a political and transition mandate. The ADB's strength is on larger public sector projects funded on a concessional basis. Cooperation has gathered momentum with inter-IFI dialogue in the context of CAREC and agreement on regional transport and energy strategies in Central Asia.

- The EBRD is also participating and has contributed to the development of complex **multi-IFI cooperation** arrangements including, for example, the Clean Energy Investment Framework implemented following the G8 Gleneagles Summit and involving the ADB, AfDB, EIB, IADB and World Bank in the area of climate change, the NDEP involving the EC, EIB, NIB, Nefco and governments on a regional environmental initiative or the efforts of the Evaluation Cooperation Group to harmonise practices and carry-out joint evaluations.

5.3 Principles of cooperation

At a time of crisis, IFI cooperation is an essential tool to offer the leveraged response that the Bank's countries of operations and clients expect and the IFIs have taken a pragmatic and responsive stance by stepping-up their joint efforts. Looking beyond the crisis, the positive elements of this enhanced cooperation should be maintained but it should be recognised that IFI co-operation is not an end in itself but rather should serve to support the EBRD's three core pillars of transition impact, additionality and sound banking. Therefore the areas for cooperation should be defined within certain boundaries.

The following operating principles should be shared by IFIs to underpin their strengthened co-operation:

- *No compromising on standards*: while it is fully recognised that different IFIs have different business approaches, no compromise should be accepted in terms of business standards (e.g., integrity, environment, credit quality). It therefore needs to be explicit that where no agreement can be reached on these principles, co-operation should not be a priority;

- *Priority to private capital*: EBRD routinely does market testing and if commercial bank funding is available on reasonable terms, then it should get included in the financing package in priority over IFI co-financing;

- *Co-financing parity*: when a deal is co-financed with another IFI, the EBRD A-loan amount and such IFI co-financing amount should be equal. If commercial bank co-financing is also raised, then the amount syndicated or sold-down should be equally allocated against the EBRD A-loan and IFI co-financing amounts[4];

- *No competition on pricing*: whereas IFIs have very different pricing structures, pricing should not be the driving factor in allocating financing amounts among IFIs. Hence IFIs should not give way to borrowers' attempts to re-allocate a financing package for the sole reason of achieving cheaper overall funding.

5.4 Focus areas for strengthened cooperation

Good cooperation is more a matter of people than of institutions, but while it cannot simply be decreed, it can be supported by an adequate institutional framework. A cooperative framework among (subsets of) IFIs could be established at three levels: (1) integrating factors, (2) pooling or division of work factors and (3) informational and process factors. The Bank will adopt a pragmatic approach, identifying initially a small set of target areas for deeper cooperation and seeking to make progress on a case-by-case basis in conjunction with the relevant IFIs.

A number of possible cooperation initiatives, based largely on the generalisation of successful individual experiences, have been elaborated by the staff Task Force on IFI Cooperation and are described in an Annex to this paper. Some of these relate to areas where specific obstacles have been faced in the past and the proposal, if implemented, would have avoided or lifted such obstacles, while others are intended to improve the efficiency of the cooperation or create new opportunities.

[4] By way of an example: if a EUR 250 million project is co-financed by EBRD and EIB, the split would EUR 125 million for each of EBRD and EIB where no commercial co-financing is available. If EUR 50 million commercial co-financing can be mobilised from commercial banks, then the split would be EUR 100 million for each of EBRD and EIB.

BOX 5: IFI COOPERATION

Cooperation with other IFIs active in the EBRD region can contribute both to an effective crisis response and to the longer-term support for the region. While there have been many successful examples of cooperation there is potential for more, and the crisis has given greater urgency to offering a “leveraged” IFI response. This in consistent with the latest declaration of the G20 as well as with long-standing requests from the donor community, clients and shareholders. Increased co-operation is also important to EBRD as its balance sheet is relatively small while it has skills and products that other IFIs do not always have.

Closer cooperation must be consistent with the objectives of the EBRD, notably its transition mandate, its additionality principle, its private sector focus and its aim to mobilise commercial co-financing. Any intensified cooperation should therefore be framed to ensure these fundamental aims of the Bank are not compromised in the long run.

Based on existing experience, enhanced IFI cooperation might be achieved through:

- integrating factors such as policy harmonisation or policy implementation alignment, agreements/MoUs providing for joint operations, common guidelines for terms and conditions, lead IFI requirements principle and sharing of funding arrangements;
- pooling or division of work on an individual project or country basis and an articulated approach relative to donors; and
- improvement of communication and information sharing through more regular exchange of information and staff contact.

Concrete proposals remain at an exploratory stage and will require careful discussion with the relevant IFIs, taking account of the prospects that the principles of cooperation set out above can be observed, as well as of the balance of effort and benefits in reaching agreement.

ANNEX: SELECTED PROPOSALS FOR DEEPENING COOPERATION AMONG IFIS

The following proposals have been developed by the staff Task Force on IFI Cooperation. They are at an exploratory stage, and will require careful discussion with the relevant IFIs before decisions can be made on whether to take any proposals forward. These decisions would need to take account of the prospects that the principles of cooperation set out in Section 6 of this paper can be observed, as well as of the balance of effort and benefits in reaching agreement.

1. Cooperation through integrating factors

Despite major political and organisational obstacles, some elements of integration ought to be envisaged as a way to rationalise efforts and leverage the impact of IFI investment:

Harmonization of policies or of policy-implementation. Policy (or policy implementation) discrepancies in joint projects (e.g. Environmental and Social, Procurement, Concessions etc.) prove to be among the most arduous issues to resolve and the most frustrating for clients (as usually the most restrictive common position is adopted). Key discrepancies that constitute obstacles to a smooth joint implementation could be identified and a harmonisation process could be explored.

Cooperation Fund with dedicated purpose. Where IFIs closely share investment objectives (e.g. EBRD and EIB in certain countries and certain sectors), cooperation funds could be established where one IFI takes the lead, originates, prepares and executes the transactions while the other IFI acts as ‘sleeping partner’ making funding available through the cooperation fund for co-financing investment in the project as ‘agented’ by the lead IFI.

Agreements/MoUs providing for joint operations. Such agreements currently in place between EBRD and EIB could be explored with other IFIs for challenging countries or challenging projects. Central Asia could be the target of a new EBRD/EIB/EC initiative (particularly in energy and private sector development) and bilateral institutions such as KfW or FMO could be involved in similar business associations. In-country frameworks could be explored for cooperation between representative offices on the ground, which may make business easier, provide more leverage in policy dialogue or simply save costs by pooling certain resources.

Common guidelines for terms and conditions. For certain categories of projects (e.g. large infrastructure PPPs), it may be practical for IFIs to reach a consensus à-la-OECD Consensus where maximum or minimum parameters and basic structural requirements would be agreed to avoid unhealthy competition. In contrast with the OECD Consensus, this harmonisation would not involve pricing, where the IFIs have fundamentally different objectives that do not afford scope for convergence.

Lead IFI requirements principle. Joint projects originated by a lead IFI and co-financed by others would greatly benefit from a single set of due diligence and, to the extent possible, policy requirements. This would also greatly expedite the financing process avoiding duplication of efforts, added costs and extra burden for clients.

Funding arrangements. Each IFI has developed funding capabilities in specific currencies which others do not share (notably for local currencies). Such capabilities could be shared with other IFIs financing the same project so that the best possible terms as far as funding is concerned are offered to clients.

2. Cooperation through pooling or division of work factors

Cooperation could be enhanced more with certain IFIs by either **pooling efforts** (to have more leverage to achieve challenging aims or to access scarce resources such as grants) or **dividing work** (so that each IFI contribute to a common objective without duplication) including the following possible measures:

Joint strategies for specific countries or specific sectors. In certain countries (notably smaller ones e.g. Tajikistan, or difficult ones e.g. Belarus) or in certain sectors (notably cross border transportation systems on a regional basis, e.g. hydrocarbon transportation systems in the Caspian area), IFIs are likely to follow similar objectives and seek identical business which could justify working on joint strategies where respective resources would be leveraged, with possibly one IFI taking the lead depending on experience and proximity. The ADB/CAREC example for Central Asia (transport and energy sectors) is an interesting precedent. In the FI sector, co-financing has been driven recently by a shortage of liquidity in the commercial market, but in the long run cooperation could be more strategic, i.e. sharing of strategies or policies to build the financial sector, rather than approach the sector on a client-by-client basis.

Joint initiatives in specialised areas such as energy efficiency/climate change and SMEs. In areas of global interest where the credit crisis restricts the availability of funding such as energy efficiency and climate change, the co-operation of IFIs through co-financing investment operations can assist in making adequate volumes of long-term funding available to deliver on the objective of pursuing sustainable energy. While certain initiatives are already under way on a global basis (e.g. the Clean Technology Fund), certain specialised initiatives are being envisaged with a regional focus (e.g. EBRD and KfW for energy efficiency in the Western Balkans, EBRD and EIB for joint credit lines to financial intermediaries to support energy efficiency investments in Poland or in the Non-Member States). Also new initiatives to jointly develop specific sectors could be explored in line with what was done between EBRD and IFC in FI (Group for Small Business) with joint equity investments.

Coordination of grant requests to donors. Better donor/IFI coordination is often advocated to avoid duplication and waste of scarce resources and facilitate the prioritisation of projects. Establishing processes to centralise grant requests and grant offers on a regional or sectoral basis (depending on donors' and IFIs' focus) could streamline this process. An excellent example is the EU's Neighbourhood Investment Facility, offering capital grants that must be co-financed by at least 2 IFIs. In an EU context, specific ideas include: (i) a dedicated grant facility for the new Member States independent from the cohesion/structural funds and open to the EBRD and EIB for specific sectors (e.g. energy efficiency); (ii) a regional investment facility for Central Asia, structured à-la-NIF and open to several IFIs (including EBRD, EIB, some bilateral agencies); and (iii) an energy and climate change facility leveraging further the EU's support to the Sustainable Energy Initiative of the Bank.

Skill based division of labour. Each IFI has developed specific skills or committed resources to a particular area allowing it to claim an expert status. Examples would be EBRD for local legal matters, EBRD or IFC for environmental and social matters, EIB for engineering matters, World Bank for reform questions. This could provide the basis for a division of labour on joint projects where each IFI would deal with its area of expertise while other IFIs would rely on the analysis and structuring. This is the organisation typically adopted by commercial banks in complex project finance transactions (technical bank, modelling bank, environmental bank, documentation bank, syndication bank etc.).

Skill based specialisation. The concept would consist of IFIs focusing on their key strengths hence specialising on certain types of deal. This could involve 'specialist IFIs' leading certain deals while 'non specialist IFIs' would be invited to participate. A similar concept is promoted by the EU for EBRD and EIB, consisting of a functional division of labour where each institution specialises on what it does best i.e. large scale financing for infrastructure for EIB and smaller scale investments, institution building, privatisation, trade facilitation, financial markets and direct equity investments for EBRD. In areas of common interest (such as SME, financing), a pragmatic approach would designate a lead institution on a case by case basis.

Pipeline sharing. The sharing of pipeline information at an early stage would improve cooperation by allowing other IFIs to direct their efforts to other clients or to approach the originating IFI with a view to jointly financing the project. It could also be considered to make this pipeline information available to key donors (e.g. EU) or interested parties (e.g. IMF).

Cross-referral of business leads for types of transaction. For transactions that need or may benefit from sharing (above a certain size or in certain sectors), leads could be referred to other IFIs based on their area of interest flagged in advance (e.g. PPPs, SMEs, renewables etc.), thus potentially leading to business cross-fertilisation.

Referral to WB/IFC advisory services. Some clients in emerging markets need advisory services to develop more complex projects (e.g. PPPs). Such advisory needs could be referred to WB/IFC (i.e., marketed by EBRD and others) in return for a right of first refusal on the financing should the transaction go ahead.

3. Cooperation through informational and process factors

Cooperation through informational and process factors can be supported through the following measures:

Message from the top. Staff across all IFIs should be given clear guidance from the top level with a joint statement of cooperation championing the process and encouraging cooperation.

Periodic joint business seminars. While the respective annual meetings are generally attended by other IFIs, dedicated multi-IFIs seminars every 6 months or every year could serve to exchange on business trends and allow multilateral contacts thus facilitating the coordination between IFIs.

Designation of liaison officers. Liaison officers at middle management level would be a new channel to exchange information, share ideas and experience, promote joint operations. While they would not have a monopoly over communications as country or sector managers would continue to deal directly with their counterparts, the liaison officers would be kept informed hence centralising information and could assist to deal with cross-departmental issues acting as a door-opener.

Code of conduct setting forth the 'etiquette' of IFI operations. Cases have been reported of business dealings including aggressive marketing or comparative business pitches, which reflect a competitive rather than cooperative approach between IFIs. Such dealings could be regulated by the adoption of an IFI code of business conduct.

Central database of IFI cooperation. Such a database could be developed at EBRD level to facilitate the analysis of IFI cooperation. It could also be designed jointly with other IFIs in the form of a joint website as a communication tool with the IFI community, government shareholders, donors and selected stakeholders (e.g. bilateral agencies, commercial banks, selected NGOs etc.).