FOURTH CAPITAL RESOURCES REVIEW 2011-2015

The formulation of the fourth Capital Resources Review (CRR4) of the EBRD covering the period 2011 to 2015 is guided by the medium-term strategic objectives endorsed by the Board of Governors at the Bank's 2009 Annual Meeting and responds to the Governors' request for a review of the Bank's capital requirements. The CRR4 contents and recommendations reflect detailed consultations with the Board of Directors and shareholder representatives, including civil society, on transition challenges facing the region, operational scenarios, the Bank's economic capital policy, financial projections, capital needs and enhancement options and the resource framework.

The CRR4 has been developed within the context of an incipient and fragile recovery from the global financial and economic crisis. The Bank's region of operations has been hit harder than others by the crisis. In 2009, GDP shrank by around 6 percent, and the social impact continues to unfold. As conditions worsened, the Bank scaled up its support. Business volume grew by almost 60 percent in 2009, to €7.9 billion, with a large share dedicated to stabilising balance sheets in the financial and corporate sectors and ensuring that critical infrastructure investment could be financed even in cases of sudden funding shortfalls.

The Bank's vigorous crisis response has gone hand in hand with a strong performance on transition impact. The Bank has promoted a coordinated IFI approach to stabilise financial systems, supported far-reaching reforms in sectors such as transport and the environment, expanded its climate change mitigation activity well in excess of CRR3 targets and, while giving renewed impetus to its central European operations and initiating operations in Turkey, has stayed the course on its commitments to the early and intermediate transition countries. Financial results have reflected the impact of the deterioration in equity valuations, but the share of non-performing assets has thus far been moderate and the budget and headcount remain within the CRR3 range.

While there have as yet been no major setbacks to transition, reform needs remain large across sectors and there is a need to regain momentum. Growth is now projected to be positive in 2010, at around 3 percent for the region as a whole, but in view of the uncertain international environment, the fiscal constraints and the damage to financial sectors there can be little confidence in forecasts for the CRR4 period. In this difficult medium-term context, demand for the Bank's funding is likely to remain high, and as a committed investor the Bank can play a particularly valuable role in supporting transition and recovery.

The Bank's operations during the CRR4 period will be guided by the strategic objectives endorsed by the Board of Governors at the 2009 Annual Meeting in London. These build on the Bank's comparative advantage as a project finance institution with a focused mandate, the capability of engaging both the public and private sectors, taking commercial risk, and a strong presence in the field. Key priorities to be pursued by the Bank over the medium term within its overall mandate to promote transition to market economies and private and entrepreneurial initiative include:

- *Building stable financial sectors.* The Bank will draw on its comparative advantage in promoting sound balance sheets and risk practices in financial institutions. More broadly, it will make a concerted effort, with other IFIs, to accelerate the development of local capital markets in order to reduce systemic vulnerabilities.
- *Diversifying economies.* Diversification of the economic base and the development of knowledge based industries are central to the future prospects for the region if it is to generate balanced growth. A new business group has been created to reinforce the Bank's engagement in these areas.
- *Tackling energy efficiency, climate change and energy security.* The Bank has the experience and capacity to leverage private sector investments for low carbon growth. Post-Copenhagen, these are valuable attributes, and investments in energy efficiency and sustainable energy projects will be a core priority accounting over time for a quarter of new business. The Bank will also work to improve energy security where consistent with its transition mandate.
- *Accelerating transition in infrastructure.* In the coming years there will be growing pressures for the region to modernise its infrastructure despite fiscal constraints. The Bank is uniquely placed to support this process by promoting a mix of ownership, management and financing models.
- *Applying the lessons of the crisis.* The crisis has uncovered weaknesses in institutions and policies. The Bank will scale up its policy dialogue in coordination with other IFIs, and develop integrated approaches that link multiple projects with the promotion of reforms and technical assistance for greater leverage and impact.

These sectoral priorities will be pursued alongside the Bank's continued commitment to shifting its operations "East and South". Organisational improvements are underway that will enable the Bank to further raise both the number and volume of operations in the Early Transition Countries. Similarly, the Bank's activities in the Western Balkans will expand further, based on a successful track record. Investment in Turkey will grow to match the country's potential and needs.

At the same time, the Bank will continue to respond to the crisis and assist recovery in its central European countries of operations. As these needs decline and financial markets resume their normal functions, the Bank's EU7 members would be expected to graduate from the Bank's regular operations during the CRR4 period. Management will work with the Board of Directors to develop a post-graduation policy in the course of this year.

The focus on quality and institutions, the expansion of sustainable energy investments and the further growth of activities in the ETC and Western Balkans regions will require an estimated technical assistance volume of €150 million per year during the CRR4 period, up from €115 million in 2009, and additional needs for non-TC grant assistance. The continued commitment of our donors is therefore crucial. At the same time, taking account of the budgetary constraints faced by many countries, it is proposed to supplement donor contributions with €50 million annually from the Shareholder Special Fund (SSF). Taking account of the implications of the proposed capital enhancement approach for the allocation of net income in the early part of the CRR4 period, it is proposed to transfer €150 million from the Bank's unrestricted reserves to the SSF in 2010.

With a clear and focused strategy, an enhanced business model, a strengthened organisation and committed donors the Bank is in a strong position to provide support to the region at a time of uncertainty. Demand for funding that meets the Bank's quality standards and strategic objectives is likely to remain high, especially in the initial years of the CRR4 period. The Bank's pipeline of eligible projects is correspondingly large, at close to €20 billion. The Bank has the operational capacity to meet this demand, and the situation in the region calls for action.

The Bank's annual business volume (ABV) should increase to up to €9 billion in 2010 and in the first two years of the CRR4 period before declining to a maximum of €8.5 billion during 2013-15. The Board of Directors would continue to set annual business plan targets within these limits. This ABV path would allow the Bank to frontload its activity in the most difficult years.

Implementing this strategy will require additional resources. Specifically, the Bank would over the CRR4 period need:

- an increase in staffing in the range of 100 to 170 (7-12 percent); and
- a cumulative real increase in the budget of between 13 and 19 percent.

The additional staff needs are driven by the further deepening of the Bank's engagement in the early transition countries and in climate change, the added emphasis on policy dialogue, an almost one-third increase in the annual number of new projects and the need to monitor a growing portfolio.

Based on full utilisation of the ABV envelope, and prudent operational assumptions, the Bank's portfolio of projects would grow by 38 percent during the CRR4 period to €44 billion at the end of 2015, while operating assets would grow by 45 percent to €32 billion. Financial projections indicate that the Bank's capital structure would continue to meet the prudential criteria established in the Bank's recently adopted Economic Capital Policy, but statutory capital utilisation thresholds would be significantly exceeded on the basis of the current capital.

Accordingly, the Bank requires additional capital to deliver its strategy. Taking account of this requirement, of the need to minimise the budgetary impact on shareholders in view of fiscal constraints, and to ensure that the capital increase is focused on crisis needs, the Bank's subscribed capital should be increased by €10 billion consisting of €9 billion in new temporary callable capital, and of adding €1 billion to paid-in capital through the conversion of unrestricted general reserves.

Unutilised callable capital could be redeemed at the end of the CRR4 period, subject to a decision by the Board of Governors, based on a prudent statutory capital utilisation threshold and following a careful assessment of the Bank's financial situation and the economic environment prevailing at the end of the CRR4 period, including in particular developments in economic output, investment, domestic banking systems and international capital markets. As such, this would not prejudge decisions that might be taken in the context of the Bank's fifth Capital Resources Review in 2015.

This approach is highly innovative for a Multilateral Development Bank. It would minimise the cost of the capital increase to shareholders, and maximise the efficiency of utilisation of the Bank's capital by significantly increasing the Bank's leverage ratio. While the Bank would need to be tightly managed, consultations with rating agencies suggest that the proposal would be consistent with a continued AAA/Aaa credit rating.

In the coming years, as the Bank moves towards the CRR5, it will engage in a strategic review covering a variety of long-term issues that have been raised by individual members. In this context, the Egyptian authorities' expression of interest to be considered as a country of operations is noted.

The EBRD region faces a challenging period in which the Bank's support will be highly relevant. The CRR4 document lays out a clear strategy, based on a detailed analysis of the opportunities and of the Bank's capabilities. A limited increase in capital will allow the Bank to make a significant contribution to recovery and transition.