Special Study

Financial Sector Operations Policy

Regional

September 2007

Evaluation Department
(EvD)

European Bank
for Reconstruction and Development

SPECIAL STUDY

PREFACE

The evaluation report

This review is an evaluation of the EBRD's Financial Sector Operations Policy and past performance in the financial sector. The review has been executed by William Keenan with assistance from Alain Davet, a financial sector consultant.

Information on operations was obtained from relevant teams and departments of the Bank and its files as well as from external sector and industry sources. The Evaluation Department would like to take this opportunity to thank those who contributed to the production of this report.

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ABBREVIATIONS

BD	Banking department
BGD	Business Group Director
CEB	Central Europe and the Baltic states
CIS	Commonwealth of Independent States
CRR	Capital resources review
ED	Environmental department
EvD	Evaluation department
FI	Financial institutions
FOPC	Financial and Operations Policies Committee
FSOP	Financial Sector Operations Policy
FYR	Former Yugoslav Republic
GSB	Group for Small Business
IFI	International finance institution
IRR	Internal rate of return
MSMEs	Micro, small and medium-sized enterprises
NBFI	Non-bank financial institutions
NA	Not applicable
OCE	Office of the Chief Economist (EBRD)
OGC	Office of the General Counsel (EBRD)
OL	Operation leader
OPER	Operation performance evaluation review
OT	Operation team
PMM	Project profitability model
SMEs	Small and medium-sized enterprises
TC	Technical cooperation
TIMS	Transition impact monitoring system
TIR	Transition impact rating
TOR	Terms of reference
XMR	Expanded monitoring report

DEFINED TERMS

the Bank	European Bank for Reconstruction and Development
the OPER Team	Staff of the Evaluation Department and the independent sector consultant who jointly carried out the post-evaluation
the Operation Team	Staff in the Banking Department and other respective departments within the Bank responsible for the Operation appraisal, negotiation and monitoring, including the XMR
the Study	EvD special study reviewing the EBRD’S Financial Sector Operations Policies and performace in the financial sector in the Bank’s countries of operations.

EXECUTIVE SUMMARY

This evaluation special study is a review of the EBRD's Financial Sector Operations Policies (FSOPs) and performance in the financial sector in the Bank's countries of operations. The principal objectives of the review are:

- to trace the development of the Bank's FSOPs through the policy documents adopted in 1992, 1996 and 1999
- to assess the Bank's performance in the financial sector
- to help identify challenges and opportunities for the future by drawing on findings of the review and other Bank material.

The study focuses in particular on the 1999 FSOP and on the manner in which investment operations signed between late 1999 and 2006 responded to the priorities set out in that document. The study assesses four components of EBRD performance in the financial sector: relevance, efficacy, efficiency and impact. The study relates these components of performance to the three transition categories that the Bank uses to measure transition impact: structure and extent of markets, market-supporting institutions and policies, and market-based behaviour.

The study assesses relevance by considering the degree to which the Bank's financial sector interventions addressed the sector reform mandate as expressed in the priorities and objectives set out in the 1999 financial sector policy. Efficacy is measured by considering the degree of success achieved by projects and operations in targeting the policy objectives. The review assesses efficiency by reference to the Bank's profitability, based on the assumption that operations that carry profits have been handled efficiently and are potentially replicable.

Impact is measured with reference to evaluation findings, ratings assigned in the transition impact monitoring system (TIMS), and the Bank's two transition impact retrospective (TIR) reports published in 2001 and 2005. The findings and conclusions of the study are based in large part on a detailed assessment of a sample of 101 signed operations representing approximately one-third of operations signed in the seven-year period.

The 1999 FSOP identified 12 policy priorities or principal objectives for the Bank's financial sector projects and operations. EvD mapped these objectives to the Bank's seven standard transition impact indicators and three transition categories. To measure relevance, the evaluation team analysed the objectives set at approval for each of the 101 projects in the evaluation sample. To assess efficacy, the evaluation team considered the degree of effectiveness of the operations in the sample by calculating the average rating score for "fulfilment of objectives".

Efficiency was measured by considering investment performance. The Review finds that the Bank's activities in the financial sector have been overall "Successful" because of "Good" relevance and "Good" transition impact and because those activities were conducted with "Good" efficacy and "Excellent" efficiency.

The evaluation team considers that the sector-level evaluation provides useful input to strategy development that could not be derived simply by scrutinising individual evaluation reports (Annex 6 contains selected lessons from EvD reports on financial institutions operations between 2001 and 2006). Nevertheless, it is interesting to note that lessons from evaluations in recent years support a principal finding of this study, namely that the Bank should make a more concerted effort in promoting investment project objectives that reinforce market-supporting institutions and policies. Lessons have highlighted the importance of transparent shareholding structures and of management structures that provide for adequate checks and balances.

In countries where the environment is being reformed only slowly, it is essential for the Bank to work with the authorities to improve the legal, regulatory and supervisory framework of the financial sector. For example, continuing due diligence is necessary to monitor the beneficial ownership of financial institutions and the possible involvement of politically exposed persons.[1] These steps are essential to build and maintain confidence in the financial sector.

Looking ahead, the Bank will have to challenge the lack of political will that persists in a number of countries hindering reforms needed to create a sustainable financial sector. As well as contributing through its legal transition initiatives to the development of a sound legal framework, the Bank can do (and has done) much to support the development of technical competence in the fields of regulation and supervision. However, these efforts will be fruitful in the long term only when they have political support in-country.

Recommendations

While the EBRD should take credit for its contribution to the transformation of the financial sector in the European Union (EU) accession countries, it is clear that some countries of operations have made much less progress along the transition path. Lessons from operation performance evaluation reviews (OPERs) and evaluation special studies in recent years confirm the continuing need for Bank support in order to increase confidence in the financial sector and further financial deepening.[2]

This study concludes with the following recommendations aimed at further enhancing the effectiveness of the Bank's FSOP. In particular, the evaluation team considers that future policy would benefit from a refocusing of priorities to target remaining transition challenges, from stronger linkages between policy priorities and investment climate initiatives, and from stronger linkages between policy dialogue and project objectives in the implementation of policy.

Clearly focused policy priorities

At the commencement of the present review, the evaluation team extracted the investment project and investment climate-related objectives from the 1999 policy document. While the document was sufficiently clear to allow the priorities to be identified, their presentation in the policy document might be regarded as somewhat diffuse. Such presentation could lead to a loss of focus in implementation over time.

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[1] EvD's annual evaluation overview report for 2007 contains a chapter entitled "Integrity in Bank Operations" addressing these issues more generally with regard to EBRD operations (BDS07-152, approved by the Board on 24 July 2007).

[2] Annex 6 contains selected lessons from EvD evaluations between 2001 and 2006.

Future statements of policy should relate strategic priorities clearly to transition challenges and transition gaps. An indication of strategic targets should be given to enable progress to be assessed periodically and policy refinements to be adopted in the light of experience.

Political support for financial sector reforms

Countries must build the technical capacity for financial sector regulation and supervision. Efforts in this direction will only succeed with in-country political backing. The Bank should consider means of structuring policy dialogue to emphasise to governments where necessary the benefits that will accrue to all stakeholders from building confidence in a privately owned financial sector.

Future policy should re-emphasise the importance of market-supporting institutions and policies

The 1999 FSOP stressed the importance of encouraging the development of sustainable financial systems though increasing the role of market processes. In EvD's view the 1999 FSOP principally targeted "market-supporting institutions and policies", followed equally by "structure and extent of markets" and "market-based behaviour". A conclusion of this study is that, from the sectoral perspective, the implementation of the policy has focused more on the latter two transition categories, certainly as concerns the objectives of investment operations.

This translates into a focus on competition, market expansion and institutional reform that has contributed strongly to the ongoing transition process in those countries that already have sufficient market-supporting institutions and policies in place. A challenge facing the Bank is to design investment operations in such a way as to stimulate and encourage the development of sound legal, regulatory and supervisory frameworks in countries where these are still lacking.

Seek to integrate policy dialogue initiatives and market-supporting TC initiatives in the design of investment operations where possible

As noted in the 1999 FSOP (Section 3.1): "The key to achieving a well functioning and stable financial system is to strengthen market mechanisms and initiatives and to support them with effective financial laws and regulations." The Financial Institutions (FI) group has achieved notable successes in stimulating institutional change at corporate level through carefully designed technical cooperation (TC) supported institutional development programmes. Continuing investment climate and policy dialogue initiatives are necessary to prepare the regulatory and legislative infrastructure for sound banking systems in the early transition countries (ETCs).

They are also vital for the development of capital markets and non-bank financial institutions in many intermediate and some advanced transition countries. With this in mind, a new financial sector policy should seek to coordinate investment operations as closely as possible with initiatives to develop market-supporting institutions and policies. For example, in developing financial sector framework facilities for countries or regions, banking teams should describe the precise nature of remaining institutional, regulatory and legislative challenges and identify policy dialogue initiatives that could mitigate those challenges.

Coordination with other IFIs

It is clear from the present study that, in spite of the Bank's significant achievements in stimulating the development of market-based financial institutions, significant challenges remain in a number of countries of operations. Given the magnitude of the task, the Bank should consider instituting formal and regular consultations with other international financial institutions (IFIs) in order to reach common ground on overcoming resistance to privatisation, develop sound prudential supervision and improve governance.

Going forward, the Bank's financial sector policy should address opportunities for concerted initiatives with other IFIs to maximise the effectiveness of the Bank's investment operations and policy dialogue. A new FSOP should set out a strategic approach to the Bank's cooperation with other IFIs.

The Bank should tailor interventions fully to initial country conditions when designing financial sector operations

In early transition economies, prerequisites for successful EBRD operations may include basic financial sector reforms such as exchange rate reunification, liberalisation of the payment system, stronger financial sector supervision, improved financial reporting and auditing, and the stimulation of minimally functioning money and capital markets. To the extent that sector-wide constraints have not been relieved by EBRD policy dialogue or other IFI initiatives, the Bank should carefully review the potential impact of these constraints on project outcomes and define project objectives accordingly.

Funding technical cooperation initiatives

The EBRD has made substantial overall returns from its financial sector interventions. The Bank should consider allocating a portion of the moneys earned to fund TC initiatives including legal transition and policy dialogue. The establishment of a TC fund from the Bank's profits to be administered by the Bank would facilitate the structured use of technical assistance in project design and implementation and enable the Bank to strengthen linkages between TC operations and investment projects.

In the case of beneficiaries who are better established financially, the use of a TC pool funded by the Bank would make it more feasible to request beneficiaries to make a contribution to costs where appropriate. EvD welcomes the recent discussions between the Board and management on expanding the scope for TC internalisation with a view to meeting, from the Bank's budget, the costs of certain operational activities and investment climate initiatives currently funded by donors.

Estimating financial returns from operations

The Bank's move southwards and eastwards is likely to result in a larger number of lower volume financial sector operations. Investments in these countries may have higher project preparation and execution costs and may entail more detailed monitoring during implementation. As discussed in Section 4.4.2, the project profitability model employed at present by the Bank shows a very low or negative projected return after risk adjustment in a significant number of cases.

The Bank's actual experience to date is rather more positive. While it is prudent and necessary to capture likely costs in the model on a reasonable basis, there is a danger that otherwise good projects may be rejected at the appraisal stage or by the Board if projected profitability is distorted by unrealistic risk adjustments.

The Bank's operating results suggest that the initiative currently under way to refine the risk adjustment mechanism in the project profitability model in order to align it more closely to actual experience is to be welcomed. Nevertheless, in future cases where project contribution after risk adjustment is anticipated to be low or negative, it will remain important to weigh the projected return against transition and market pricing considerations.

SPECIAL STUDY
FINANCIAL SECTOR OPERATIONS POLICY (FSOP)

1. Introduction

1.1 Background and approach to the financial sector review

This evaluation special study is a review of the European Bank for Reconstruction and Development's (EBRD) Financial Sector Operations Policies (FSOPs) and performance in the financial sector in the Bank's countries of operations. The study has been carried out by the Bank's independent Evaluation Department (EvD). The review is also intended to assist the Bank in updating its policy for the financial sector. The principal objectives of the review are:

- to trace the development of the Bank's financial sector operations policies through the policy documents adopted in 1992, 1996 and 1999
- to assess the Bank's performance in the financial sector
- to help identify challenges and opportunities for the future, drawing on findings of the review and other Bank material.

This study was undertaken with a view to the Bank's operations refocusing southwards and eastwards while gradually withdrawing from the more advanced transition countries. The Bank climbed a steep learning curve in the first decade of operations. While many lessons from the early years have successfully been realised, especially with regards to central Europe and the Baltic states, EvD considers that many lessons remain relevant to operations in other countries, including the ETCs.

In assessing the Bank's performance in the financial sector, the study focuses in particular on the 1999 financial sector policy and on how investment operations signed between late 1999 and 2006 responded to the priorities set out in the 1999 policy document. It is worth recalling that the 1999 policy was prepared in the aftermath of the 1998 banking crisis in Russia. The policy document noted:

"The Russian crisis and its repercussions throughout the region, in particular, have revealed the considerable risks in transition banking, arising from both macroeconomic instability and structural weaknesses within the banking sector itself. These risks are greatest in countries at earlier stages of transition."

These observations remain pertinent to a number of the Bank's countries of operations today. While the Bank has made efforts through its Legal Transition Programme, as well as through the influence of investment operations, to bring about systemic and regulatory changes in the financial sector, not all countries have responded as the Bank would have wished. In the case of Russia, for example, the EBRD publication *Law in Transition* noted in October 2005:

"In Russia, after the financial crisis of 1998, authorities made significant efforts to protect the banking sector from any future crisis." However, the assessment observed that "regulation of banking activities and ongoing supervision in Russia is unsatisfactory. There are deficiencies within lending and investment regulation, in particular with formulating internal policies and procedures for granting credit and making investments and with lending to connected and related parties. Another area that needs attention is the establishment of clear policies and procedures to identify risks that banks face in their activities."

Overall, the assessment concluded: "In general, transition countries tend to have good legislation relating to the start up of new banks, but weak legislation related to continuing supervision. This is particularly the case for issues relating to the disclosure of beneficial ownerships and the consolidated supervision of banking groups."

In spite of the continued shortcomings in a number of areas of banking legislation, a finding of the present study is that the Bank has achieved strong transition impacts in the financial sector through investment operations and other initiatives. Moreover, these impacts have translated into good financial returns for the Bank during a lengthy period of growth in economic activity in most of the region. The conclusion may be that, if impacts and returns are to be sustainable during a less favourable economic climate, the Bank must strongly encourage country legislatures to enact improvements of the financial sector.

1.2 Assessing financial sector performance

The present review employs and refines the evaluation methodology developed by EvD and applied in the evaluations of the EBRD's Telecommunications and Property Sector Policies. The study assesses four components of EBRD performance in the financial sector: relevance, efficacy, efficiency and impact. The study relates these components of performance to the three transition categories that the Bank uses to measure transition impact: structure and extent of markets, market-supporting institutions and policies, and market-based behaviour.[1]

The study assesses relevance by considering the degree to which the Bank's financial sector interventions addressed the sector reform mandate as expressed in the priorities and objectives set out in the 1999 financial sector policy. Efficacy is measured by considering the degree of success achieved by projects and operations in targeting the policy objectives. The review assesses efficiency by reference to the Bank's profitability, based on the assumption that operations that carry profits have been handled efficiently and are potentially replicable.

For the purposes of this study, impact is measured with reference to evaluation findings, ratings assigned in the transition impact monitoring system (TIMS), and the Bank's two transition impact retrospective (TIR) reports published in 2001 and 2005. The Bank's 1999 FSOP document stated clearly: "The refocused operational policy takes a more systemic view, with particular emphasis on how the Bank's operations affect the development of the financial system as a whole." It follows that this evaluation of the policy and its implementation should have regard to how the Bank's operations have affected financial sector development.

1.3 Identifying the population of FI operations and selecting the sample for analysis

A total of 302 financial institutions (FI) operations, comprising standalone projects and frameworks, were signed between the final quarter of 1999 and 2006. These do not include operations handled exclusively by the EBRD's Group for Small Business (GSB). In addition, there were a number of technical cooperation (TC) operations designed primarily with institutional reform in mind and a series of investment climate initiatives in the form of policy dialogue.

The Bank's operations in the financial sector cover the following areas:

[1] The three transition categories break down into seven transition impact indicators. See Section 2.5 and Annex 1.

- bank lending (that is, credit lines to partner banks generally for on-lending to private businesses)
- bank equity (where the Bank takes a minority equity stake and seeks to contribute to sound governance as well as improving operational and financial performance)
- equity funds
- non-bank financial institutions.

In the early years the Bank founded and contributed the majority of capital to a number of newly established equity funds. Substantial TC funds were utilised alongside the Bank's capital to introduce this type of funding in central Europe and the Baltic states (CEB), Russia and some countries in Central Asia, the Caucasus and western Commonwealth of Independent States (CIS). As conditions became more conducive to private equity operations in some countries, the Bank participated as a minority equity contributor to a number of funds with private sponsors and without technical assistance funds.

The findings and conclusions of this study are based in large part on a detailed assessment of a sample of 101 signed operations and the manner in which they responded to the 1999 financial sector policy objectives. The sample, representing approximately one-third of operations signed in the seven-year period, comprises:

- 40 operations evaluated independently by EvD
- 31 operations for which bankers prepared self-assessment reports, but which were not evaluated by EvD
- a further 30 operations selected by the evaluation team to obtain a reasonable distribution of the total sample across countries of operations and project types.

2. The Bank's financial sector operations

This section of the study gives an overview of the development of financial sector operations policy as reflected in the policy documents approved in 1992, 1996 and 1999. Annex 1 outlines the 1999 financial sector policy objectives in tabular form.

2.1 FSOP 1992: establishing market-oriented financial institutions and initial steps in financial reform

In 1992 the EBRD Board considered and approved a paper on the Bank's FSOP and a background paper on financial sector issues. In its concluding observations, the background paper noted that urgent solutions were required to the pressing problems of financial sector reform and transition. Financial sector reform had to be coordinated with overall economic restructuring and rehabilitation of enterprises before, during and after they were privatised. The Bank should emphasise the importance of sound banking institutions and the establishment of a credit culture with a well-founded legal and regulatory framework, increased accountability, improved financial information and greater transparency.

The paper acknowledged that the pace of reform and the Bank's emphasis would depend on the current status of reform and government priorities in each country. It goes without saying that countries have performed in widely different ways in the intervening 15 years and that the 1992 observations are still relevant to a number of countries today. In response to the conditions described in the background paper, the 1992 policy document focused on the establishment of market-oriented financial institutions.

The policy gave high priority to investment projects aimed at improving the performance of existing banks, often in conjunction with their privatisation, and to supporting the creation of new private banks. The policy anticipated that greater competition among banks would work to improve their individual quality and to encourage new sources of financing for the private sector.

Appropriate government initiatives would be necessary to underpin financial sector development, particularly by having central banks divest themselves of commercial lending activities and by developing the skills needed for effective regulation and prudential supervision of the sector. A corollary was the improvement of accounting and reporting standards in commercial banks.

2.2 FSOP 1996: financing the real sector, institution building at project level and financial deepening

In July 1996 the Financial and Operations Policies Committee (FOPC) and the Board approved a revised FSOP following a policy review begun the previous year. The 1996 policy identified two principal objectives of the Bank's financial sector activities, namely institutional strengthening and intermediation, which together would contribute to much-needed financial deepening. The Board acknowledged that implementation would differ across the countries of operations, depending on local circumstances, including differences in progress in the transition.

Accordingly, the new policy noted that the scope for the Bank's use of some instruments increases while the applicability of others decreases as countries move through the stages of transition. The three stages were

- early transition, where the Bank's focus would be on contributing to an enabling environment
- medium transition, where the priority was sector restructuring
- advanced transition where the priority would be institutional development.

Overall, the principal focus of the 1996 policy was institution building at the project level with a view to increased financing of the real sector. In this connection the Bank would give high priority to supporting private equity funds and providing small and medium-sized enterprise (SME) credit lines to local banks combined with the use of TC funds.

2.3 FSOP 1999: increasing the role of market processes and government in fostering financial sector development and sustainability

If three distinct "stages of transition" had been identified by 1996, after some five years of Bank operations in the financial sector, the gulf between advanced and early transition countries had widened even more by the time of the next and most recent financial sector operations policy, which was approved in July 1999. The 1999 FSOP paper stated that it "reviews and refocuses" the FSOP taking "a more systemic view, with particular emphasis on how the Bank's operations affect the development of the financial system as a whole." The document identified a set of operational priorities with one key overall objective that it expressed as follows:

"The key to achieving a well functioning and stable financial system is to strengthen market mechanisms and initiatives and to support them with effective financial laws and regulations. The Bank's financial sector operations policy should thus focus on the overall objective of promoting **confidence** and **competition** in an independent financial system. This policy aims to translate these broad objectives into concrete criteria for the **selection and design of investment projects** in the financial sector and to identify priorities for **investment climate initiatives.**"[2]

The implementation of the FSOP and the results of the Bank's various operations in the sector, should be evaluated with reference to the declared and approved overall objective of promoting confidence and competition in an independent financial system. The primary focus of the policy objectives enumerated in the document was *sustainability* (EvD emphasis). This was to be achieved by promoting confidence and competition through attention to the increased role of market processes and of government. High priority was given to:

- strengthening the commercial orientation of state-owned financial institutions
- supporting privatisation
- facilitating foreign direct investment
- promoting the consolidation of financial institutions through mergers and acquisitions.

Government also had a role in developing legal, regulatory and supervisory frameworks that would permit financial institutions to operate in a market environment. The Bank would seek to help create new markets for financial services or extend their reach to new customers. The policy envisaged a strengthened corporate governance role for the Bank vis-à-vis its clients with attention also to the transfer of skills and technologies needed in a well functioning market-oriented financial system.

2.4 The first TIR, 2001, and the transition path

In February 2001 the Bank published a TIR that had been undertaken as part of the second capital resources review (CRR2). The purpose of the TIR was to identify the pattern of the Bank's successes and under-achievements in promoting transition on a country and sector basis and to relate this pattern to conditions in the operating environment as well as to project choice and design. The TIR adopted what it described as a pragmatic approach that emphasised group judgements, drawing on views from within the Bank, primarily from country and sector teams, the Office of the Chief Economist (OCE) and EvD.

The companion paper to the TIR identified for each of 12 sectors a transition path, or "event line", and remaining transition challenges. Three of the "sectors" addressed in the TIR – banking, non-bank financial institutions (NBFIs) and SMEs, may be considered sub-sectors of the wider financial sector. The 2005 TIR, which was undertaken in connection with the third capital resources review (CRR3), added a further sub-sector, private equity funds. In describing the transition path for the banking sector, the 2001 TIR companion paper observed that building a banking system on market principles in the Bank's countries of operations involves the transformation of state banks into market-based institutions and/or entry by new private sector participants.

The TIR outlined certain steps needed in the transition process, though not necessarily in sequence. A number of steps were common to the banking, NBFI and SME sectors as defined in the 2001 TIR. Common steps included:

- reform of regulation (including prudential regulation)
- development of the legal framework
- liberalisation of entry and exit

[2] Financial Sector Operations Policy, BDS99-63 (Final), page 20 – emphasis as in original.

- development of business practices and corporate governance.

Steps specific to reforming the banking sector were:

- recapitalisation and successive privatisation of state-owned banks within a competitive industry structure
- deepening of financial intermediation, broadening of services (including retail products) and stabilisation and diversification of funding sources.

The 1999 FSOP was developed before the CRR2 and the TIR. However, it can be seen from the above discussion and from Table 1, which follows in Section 2.5, that the policy document anticipated the principal issues subsequently identified in the TIR.

2.5 1999 FSOP: transition impact indicators and related policy objectives

As noted above, this evaluation takes as its principal focus the implementation of the 1999 policy. Table 1 maps to the Bank's transition categories and transition impact indicators and the objectives in the 1999 policy relating to investment projects.

Table 1: 1999 FSOP policy objectives relating to investment projects

Transition categories	**Transition impact indicators**	**Financial sector policy objectives relating to investment projects**
Structure and extent of markets	1. Competition	1.1 Add to the alternative sources of financing
		1.2 Promote efficiency and client orientation to increase competition
	2. Market expansion	2.1 Extend financial sector coverage to new types of customer, especially private sector and SMEs
		2.2 Broaden range of providers of financial instruments (banks, non-banks and specialised institutions)
Market-supporting institutions and policies	3. Private ownership	3.1 Strengthen commercial orientation of state-owned FIs through restructuring and privatisation
		3.2 Facilitate foreign direct investment
	4. Frameworks for markets	4.1 Consolidation of financial institutions through mergers and liquidation
Market-based behaviour	5. Skills transfer	5.1 Transfer skills and technology to local FIs
	6. Demonstration effects	6.1 Broaden geographical coverage of the financial sector; support expansion of local institutions that have performed well
	7. New standards for business conduct	7.1 Improve governance through participation in Boards
		7.2 Strengthen business practices of local FIs
		7.3 Improve transparency and disclosure standards

It can be seen from the table that each transition category and indicator was targeted by one or more policy objective. If the number of objectives is taken as a guide to the weight given to a transition category, then the table illustrates that "market-based behaviour" was the main target of the policy, followed by "structure and extent of markets" and "market-supporting institutions and policies". It seems appropriate that investment project objectives should target primarily issues and challenges that investment operations are capable of addressing.

Therefore the policy objectives appear to be reasonably well targeted to address the Bank's transition goals. The policy objectives reflect the new emphasis on sustainability (market-based behaviour to build confidence) together with a re-emphasis on financial deepening (structure and extent of markets – competition and market expansion).

The 1999 FSOP contained also a number of policy objectives to be implemented through what it described as investment climate initiatives. The distribution of these is more weighted in support of ‘market-supporting institutions and policies’. In fact, four of five policy objectives identified by the evaluation team as relating to investment climate initiatives, involve market-supporting initiatives and one addresses “structure and extent of markets”.[3]

The table in Annex 1 maps both sets of policy objectives (relating to investment projects and investment climate initiatives) to the transition indicators. If one considers both the objectives relating to investment projects and those relating to investment climate initiatives, then it appears that the 1999 FSOP targeted principally ‘market supporting institutions and policies’, followed equally by ‘structure and extent of markets’ and ‘market-based behaviour’.

Overall, in the evaluation team’s view, the policy document adopted a balanced approach to financial deepening and sustainability. Section 3 gives an overview of the Bank’s financial sector activities including TC operations. Section 4 considers performance at the sector level in the context of the policy priorities and objectives.

The evaluation team extracted the investment project and investment climate related objectives from the policy document. Future policy documents should draw on the work of the Transition Impact Retrospectives, which were not available when the 1999 FSOP was being prepared, and state clearly how policy objectives address transition challenges.

3. The Bank’s financial sector activities

3.1 The Bank’s financial sector portfolio

The EBRD’s FI group reports internally on the Bank’s financial sector portfolio. This is done annually providing an overview of portfolio developments in the previous year together with an analysis of product groups and country exposures. Microfinance activities are included as a separate product group managed by the GSB. The report as a rule also discusses TC activities in the period, policy dialogue and cooperation with other institutions. It also gives a detailed analysis (country by country) of outstanding transition challenges and the proposed Bank response.

3.2 EvD’s overview of trends in investment operations in the financial sector

The Bank’s business activities in the financial sector are analysed by five product groups:

- bank debt
- bank equity
- equity funds
- NBFI
- GSB, responsible for microfinance.

Formally, the GSB is managed by a different Business Group Director than the FI group. This review does not address the microfinance operations of the GSB, some aspects of which were considered in an earlier EvD special study on delivery mechanisms for micro, small and

[3] The market-supporting policy objectives are: effective prudential regulation and supervision of banks and NBFIs; improving legal and institutional arrangements for resolution of failed FIs; acceptable accounting and auditing practices; support for Legal Transition to upgrade legislation systems governing secured transactions; and promoting confidence and competition in an independent financial system free of arbitrary government influence and business capture. See also Section 4.2.2 and Annex 1.

medium-sized enterprise (MSME) financing.[4] EvD is proposing to carry out an evaluation special study of the Bank's small business financing operations policy in its 2008 work programme.

Numbers of operations

The tables in Annex 2 show the number of financial sector projects, excluding GSB microfinance, signed per country per year, and the number of projects per sub-sector (or product group) per year.[5] It can be seen that the number of operations peaked at around 50 annually in the mid-nineties prior to the Russian financial and banking crisis of 1998 which had repercussions around the region. The number of operations began to approach this level once more about five years after the crisis.

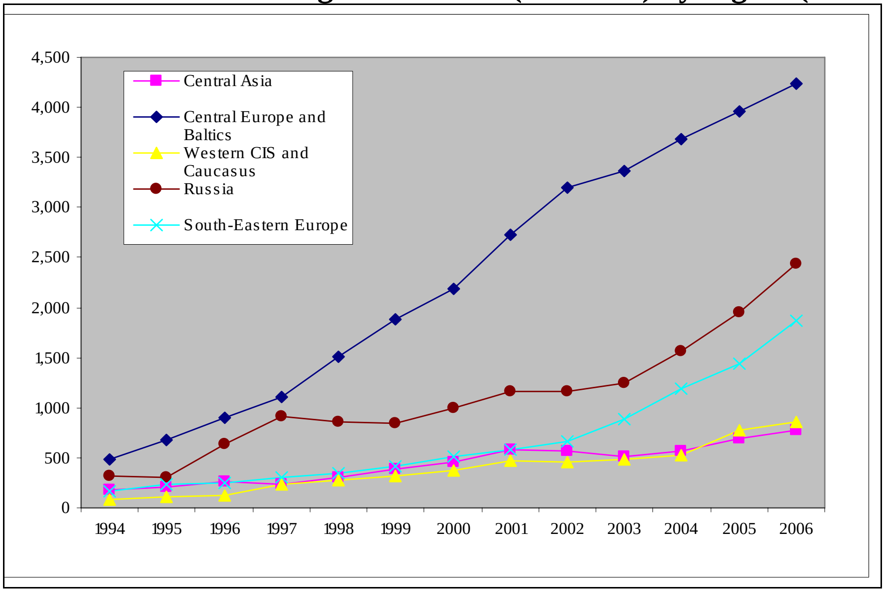
The years 2005 and 2006 were record years with 57 and 60 projects respectively. It is interesting to note that, as regards those countries with more than 20 signed operations cumulatively by December 2006, the number of operations has been falling in recent years. This has happened in countries with more developed banking sectors, especially Croatia, Estonia, Hungary and Poland. By contrast the number of operations continues to rise in Russia and Ukraine, countries in which the Bank experienced some difficulty for a time identifying suitable partners among local banks.

As regards the distribution of projects by sub-sector, bank lending outweighs the other product groups by number in most years and cumulatively. By December 2006 bank lending comprised 255 signed projects compared with 146 for bank equity, 106 for equity funds and 73 for NBFI. This is consistent with the Bank's policy to stimulate competition, market expansion and market-based behaviour in the sector, as well as increasing funding for private business, through the instrument of Bank-to-bank credit lines for on-lending to the real sector.

Volumes of operations

It is interesting also to consider the cumulative volumes of signed projects by region and by sub-sector, as illustrated in the following charts.

Chart 1: Cumulative signed volumes (€ million) by region (excluding GSB)



Source: EBRD Data Warehouse

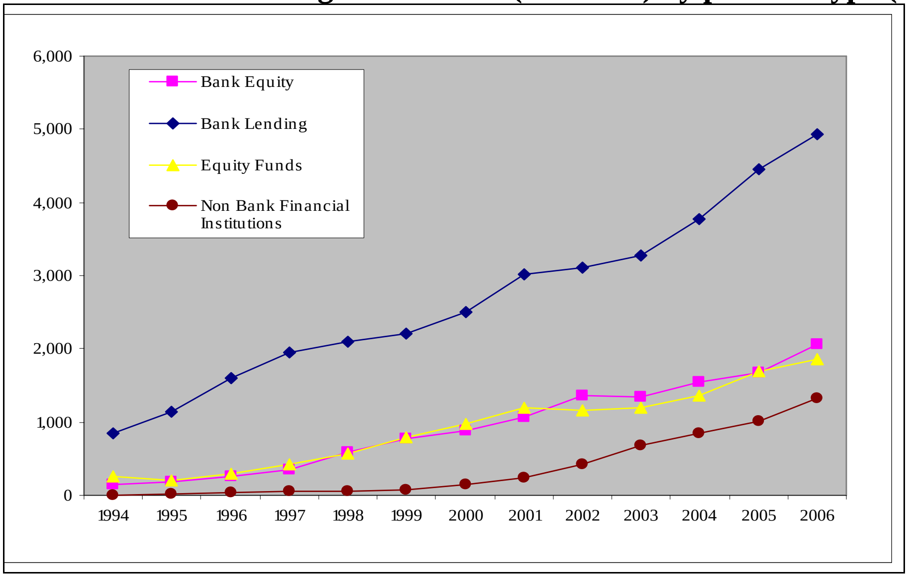
[4] *Delivery Mechanisms for MSME Financing, A Synthesis Report (Regional)*, Special Study, January 2005.

[5] For the purpose of this study, each standalone operation and each framework is counted as a "project".

Chart 1 shows that by December 2006 the Bank had signed around €4.3 billion of business in the financial sector in the countries of central Europe and the Baltic states; approximately €2.5 billion in Russia; €1.7 billion in south-eastern Europe; and around €0.7 billion in both Central Asia, and the western CIS and the Caucasus. It is not surprising that the largest volume and fastest growth of business was in the more advanced countries.

The chart illustrates that in recent years the volume of new business in the advanced countries has been growing at a slower pace, while new business in Russia and south-eastern Europe has been increasing sharply. A more modest pace of business growth is observed in western CIS and the Caucasus, and Central Asia.

Chart 2: Cumulative signed volumes (€ million) by product type (excluding GSB)



Source: EBRD Data Warehouse

Chart 2 illustrates that bank lending (that is bank-to-bank credit lines, for the most part for on-lending to private businesses) has been the FI group's main product, reaching around €5 billion by 2006 and far outpacing other sub-sectors. The volume of business in the NBFI sub-sector began to grow around 2000 and has been increasing at a steady pace to reach a cumulative volume of €1.2 billion by the end of 2006. Cumulatively, the bank equity and equity funds teams have each written approximately €2 billion of business. It is worth noting that equity investments have made the most significant contribution to Bank profits in recent years.

3.3 December 2006 portfolio

The tables in the preceding section illustrate the growth in cumulative volumes. This does not necessarily represent the condition of the portfolio currently. As at December 2006, the Bank's aggregate portfolio in the financial sector (excluding the GSB) amounted to €5.5 billion. Charts 3 and 4 illustrate the breakdown of the portfolio by product type and region. Annex 3 shows the breakdown by country.

Charts 3: FI group portfolio 31 December 2006 (excluding GSB), by operation type

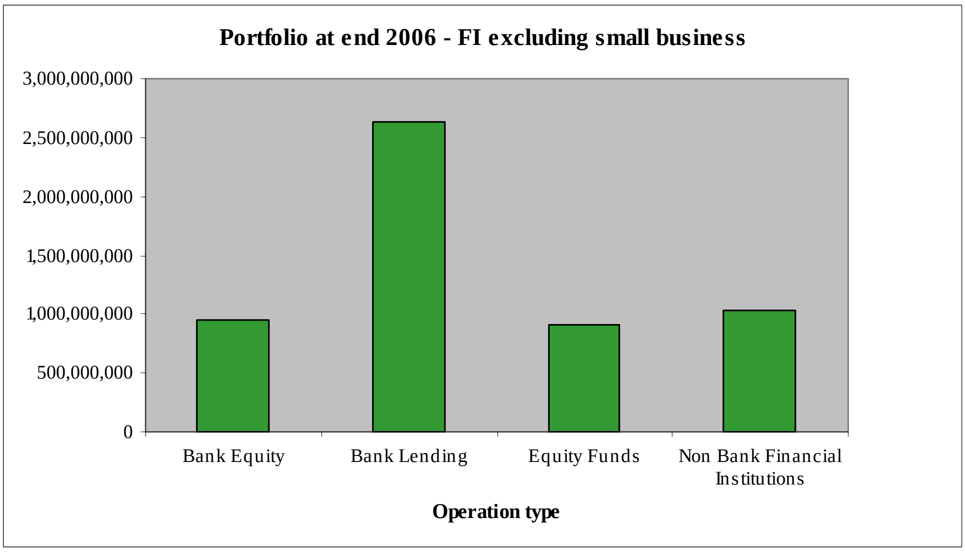
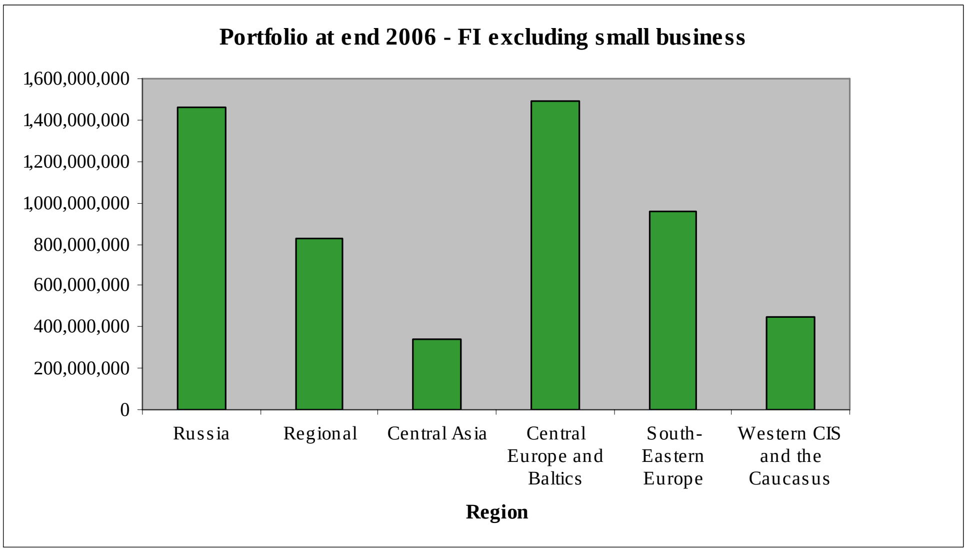


Chart 4: FI group portfolio 31 December 2006 (excluding GSB), by region



Source: EBRD Data Warehouse

By comparing charts 3 and 4 illustrating the December 2006 portfolio with the cumulative volume charts 1 and 2, one can see that NBFI business has grown from a very small base at the turn of the century to represent almost 19 per cent of the current portfolio excluding the GSB. Indeed, in volume terms, NBFI business now marginally exceeds bank equity and equity funds.

The contrast in geographical terms should also be noted. Table 2 has been compiled from the data underlying the cumulative volume and portfolio charts above.

Table 2: FI cumulative volume and outstanding portfolio (excluding GSB), December 2006

	Cumulative business volume to December 2006		Outstanding portfolio at December 2006	
	€ million	% of total	€ million	% of total
Central Europe and the Baltic states	3,565	35	1,488	27
Russia	2,272	22	1,462	27
South-eastern Europe	1,595	16	956	17
Western CIS and the Caucasus	771	8	449	8
Central Asia	749	7	341	6
Regional	1,225	12	824	15
Total	10,177	100	5,520	100

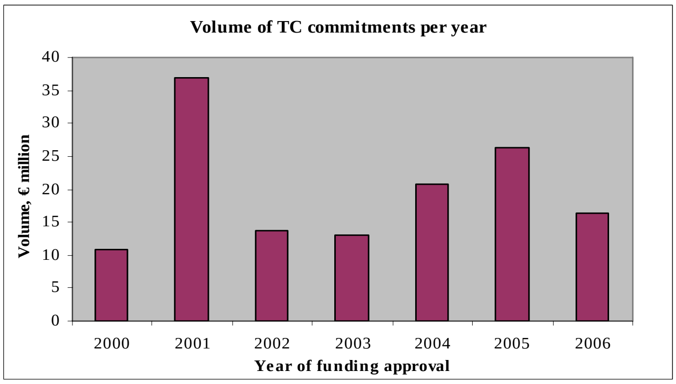
Source: EBRD Data Warehouse

The table illustrates that the proportion of operations in central Europe and the Baltic states in the Bank's portfolio is falling in terms of volume. The table also illustrates clearly the importance of Russia in the Bank's current FI portfolio. The outstanding portfolio in Russia at the end of 2006 almost equals the combined portfolio of the nine countries making up central Europe and the Baltic states. A further point to emerge from the table is the magnitude of the task facing the Bank as it attempts to increase portfolio volume in other regions.

3.4 Overview of TC operations in the financial sector

Charts 5 and 6 show the volume and number of TC commitments per year between 2000 and 2006 by year of funding approval. Further charts in Annex 4 show the breakdown by industry sub-sector (product group), type of TC operation (such as project implementation or advisory services) and geographic region.[6]

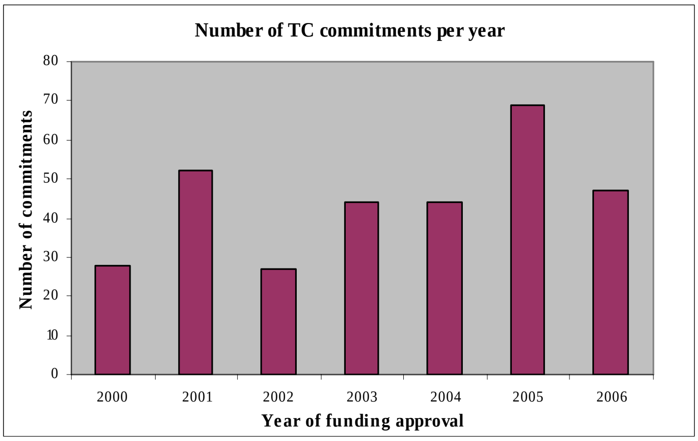
Chart 5



Source: EBRD Data Warehouse

[6] It should be noted that the tables illustrate the level of TC commitments by year of funding approval and may not accurately represent levels of activity from year to year. Many TC commitments are multi-year.

Chart 6



Source: EBRD Data Warehouse

Over the seven-year period from 2000 to 2006, approximately €138 million of TC expenditure was approved on 311 commitments. It can be seen from the charts above that there was a peak in the volume of commitments in 2001 when €37 million was approved. This was accounted for in large part by the EU-Phare SME facility (SME Finance Facility Special Fund for the 10 accession countries) which amounted to around €21.6 million.

Around 60 per cent of commitments by volume and by number concerned depository credit (that is, banking) operations and around 86 per cent of commitments by volume (66 per cent by number) were to support project implementation and institution-building. Almost 60 per cent of all commitments by volume were classified as 'Regional', although they accounted for 32 per cent by number of commitments illustrating the importance of donor-supported regional technical assistance programmes to the Bank's operations. Table 4 shows the geographical split:

Table 4: Geographical distribution of TC commitments 2000-06

	% by volume	% by number
CEB	3	5
SEE	10	15
Russia	12	15
Other CIS	10	15
ETCs	6	18
Regional	59	32
Total	100	100

Source: EBRD Data Warehouse

In terms of the Bank's transition categories, the majority of TC operations, by their nature, focus on market-based behaviour rather than structure and extent of markets and market-supporting institutions and policies. As noted above, a large proportion of TC operations was intended to support project implementation.

This indicates that the Bank's TC-funded interventions had a predominantly reinforcing role in relation to investment operations. TC-funded institutional reform initiatives, including corrective action plans and institutional development programmes, have played an important role in establishing confidence and building competitiveness and sustainability.

A report prepared by the FI group focused on technical assistance dedicated to improvements in banks and banking systems in the EBRD's first 10 years of operations. A key finding of the FI report was that unsuccessful TC projects tend to be clustered in a limited number of countries, confirming the important influence of the business environment on partner bank performance. Although a full analysis of TC effectiveness is outside the scope of this study, it is interesting to consider the self-assessed performance ratings attributed by bankers in TC project completion reports (PCRs).

PCRs have been completed for 163 (52 per cent) of the 311 TC commitments supporting FI operations between 2000 and 2006 and the self-assessments awarded overall performance ratings of "Good" or "Excellent" to 89 per cent of these. It is worth noting that this is consistent with the proportion of "Highly Successful" and "Successful" TC operations recorded in EvD's recent study on PCRs.[7] EvD concludes that TC funds have been targeted appropriately to support the implementation of FI investment operations and institutional reform programmes associated with them.

4. Sector level performance

4.1 Introduction to the assessment of the Bank's sector level performance

The assessment of sector level performance focuses on the extent to which the Bank's FI operations since 2000 have addressed the priorities for the sector set out in the 1999 FSOP. This is considered on the basis of relevance, efficacy, efficiency and impact. Based on analysis of the evaluation sample, ratings are derived for sector level performance under each of these headings. There remains the question of how well the policy itself was targeted.

An attempt is made to answer this question by referring to the remaining transition challenges identified in the 2005 TIR and comparing the present status with the status at the time of the 1999 policy document. This chapter of the review then reaches an overall sector performance rating for the Bank's financial sector operations.

4.2.1 Relevance of investment operations

As noted in Section 2.5, the 1999 FSOP identified twelve policy priorities or principal objectives for the Bank's financial sector projects and operations. The evaluation team has mapped these objectives to the Bank's seven standard transition impact indicators and three transition categories, as illustrated in the table in Section 2.5. To measure relevance, the evaluation team first listed the objectives set at approval for each of the 101 projects in the evaluation sample. Table 5 shows the number of projects addressing each objective.

Table 5: Number of projects in the evaluation sample addressing each policy objective

TI category/ TI indicator	**No. of FSOP objectives**	**No. of projects addressing objectives**
Structure and extent of markets	***4***	***96***
Competition	2	58
Market expansion	2	86
Market-supporting institutions and policies	***3***	***33***
Private ownership	2	26
Frameworks for markets	1	9
Market-based behaviour	***5***	***66***
Skill transfer	1	29
Demonstration effects	1	20
Improved standards	3	55

[7] PCR assessment report (Technical cooperation operations), Special Study, May 2007.

The table illustrates that 96 out of the 101 operations in the sample addressed “structure and extent of markets”. Among these the primary target was “market expansion” (86), while 58 projects also targeted “competition’. About two-thirds of projects (66) addressed “market-based behaviour”, with about one-third (33) addressing “market-supporting institutions and policies”. Within “market-based behaviour” attention was given most frequently to “improved standards” (55). As regards market-supporting objectives, around one-quarter of the sample (26) aimed to stimulate “private ownership” and nine projects addressed “frameworks for markets”.

4.2.2 Relevance of investment climate initiatives (in relation to the policy)

Policy dialogue initiatives undertaken by the EBRD with country authorities represented by various agencies and ministries relate to six broad categories defined in the 1999 FSOP as follows:

- promoting confidence and competition in an independent financial system free of arbitrary government influence and business capture
- effective prudential regulation and supervision of banks and non-bank FIs
- improving legal and institutional arrangements for resolution of failed FIs
- acceptable accounting and auditing practices
- support for legal transition to upgrade legislative system governing secured transactions
- other issues.

The first initiative listed above relates to the transition category “structure and extent of markets”, while the remaining initiatives target “market supporting institutions and policies”. Each of the Bank’s countries of operations was a beneficiary of one or another investment climate initiative over the five year period from 2002 to 2006.

Policy dialogue initiatives aimed at promoting confidence and competition, in other words at improving the “structure and extent of markets”, targeted some 74 per cent of countries (20). Around 74 per cent of countries benefited from initiatives aimed at prudential regulation and supervision, while support for legal transition sought to address the needs of 89 per cent of countries (24).

It appears that EBRD assistance in the form of investment climate initiatives has been focussed in particular on “market supporting institutions and policies” via legal transition and promotion of effective regulation. This contrasts with the emphasis of investment operations on “structure and extent of markets” and “market-based behaviour”. Various aspects of a developed financial market have been approached – for example, law on banks, bankruptcy law, securities law, leasing – depending on the transition stage of different countries.

Another focus of the Bank’s concern has been anti-money laundering. The Bank has also assisted several more advanced countries in three major areas: the development of an insurance market, pensions reform and securitisation, mostly of mortgage loans.

4.2.3 Relevance rating

Table 6 summarises the findings with regard to the relevance of the Bank's investment operations and investment climate initiatives discussed above.[8]

Table 6: Relevance ratings

	Investment operations		**Investment climate initiatives**		**All intervention s**
TI category	No. projects addressing objectives	% of projects addressing objectives	No. countries receiving assistance	% of countries receiving assistance	**Relevance rating**
Structure and extent of markets	96	95	20	74	***Excellent***
Market-supporting institutions and policies	33	33	24	89	***Satisfactory***
Market-based behaviour	66	65	na	0	***Good***

An overwhelming number of financial sector investment operations between late 1999 and 2006 addressed objectives related to 'structure and extent of markets' as defined in terms of priorities set out in the 1999 FSOP. Some two-thirds of projects also had objectives related to 'market-based behaviour', for example by specifically promoting skills transfer or improved business standards.

However, only one-third of investment operations can be said to have targeted specifically "market-supporting institutions and policies" although around 90 per cent of the Bank's countries of operations benefited from policy dialogue addressing legal transition or prudential regulation.

On the basis of the above analysis, the evaluation team assigns a relevance rating of "Good" to the Bank's operations in the financial sector. Nevertheless, the analysis suggests that there may be scope to tighten linkages between policy dialogue and investment operations in the financial sector.

4.3 Efficacy

To assess the efficacy of the Bank's operational response to the 1999 FSOP, the evaluation team considered the degree of effectiveness of the financial sector investment operations in the sample. The degree of effectiveness is estimated by calculating the average rating score for the fulfilment of objectives.[9] On this basis, Table 7 shows the average efficacy ratings of the 101 sample operations against the Bank's standard transition categories and indicators.

[8] TC operations have had a predominantly supporting and reinforcing role in relation to investment operations (see Section 3.5 and Annex 4). In the evaluation team's view their function has been largely to complement the Bank's financial sector interventions through supporting the implementation of project-level objectives.
[9] For this purpose EvD's standard rating scale is graded as follows: 1 = excellent; 2 = good; 3 = satisfactory; 4 = marginal; 5 = unsatisfactory; 6 = highly unsatisfactory.

Table 7: Efficacy of sample investment projects[10]

TI category TI indicator	No. of FSOP objectives	No. of projects addressing objectives	Average efficacy rating
Structure and extent of markets	***4***	***96***	***2.28***
Competition	2	58	2.24
Market expansion	2	86	2.29
Market-supporting inst'ns and policies	***3***	***33***	***2.29***
Private ownership	2	26	2.38
Frameworks for markets	1	9	2.00
Market-based behaviour	***5***	***66***	***2.29***
Skill transfer	1	29	2.34
Demonstration effects	1	20	2.20
Improved standards	3	55	2.29
Overall	***12***	***101***	***2.28***

Note: Rating key: 1 = excellent; 2 = good; 3 = satisfactory; 4 = marginal; 5 = unsatisfactory; 6 = highly unsatisfactory.

The table shows an average efficacy rating of close to "Good" for the operations in the sample within a fairly narrow range. While it is important to avoid spurious accuracy, it is interesting to note that the highest efficacy score is recorded for projects addressing "frameworks for markets", although this transition indicator received the least coverage being addressed by only nine operations in the sample.

The low number of operations targeting "frameworks for markets" may be explained by the fact that only one ("consolidation of financial institutions through mergers and liquidation") out of seven FSOP priorities addressed this indicator. It is likely that the Bank would only target such an objective with an investment operation in clearly defined circumstances, which may help explain the apparently higher degree of efficacy of operations addressing this indicator.

4.4.1 Efficiency

To measure the efficiency of the Bank's operational response to the 1999 FSOP, EvD considered the investment performance of the FI portfolio. Using calculations based on the Bank's profitability model, it is possible to estimate the gross and net internal return rate (IRR) on investment of debt operations and equity investments.[11] Using a December 2005 cut-off, EvD estimated the return on operations signed between 2000 and 2005, dividing these into active and completed operations. Table 8 summarises the results of the exercise.

Table 8: FI operations gross and net return on investment before provisions 2000-05 (excluding GSB)

	Active operations		**Completed operations**		**All operations**	
	Gross IRR	Net IRR	Gross IRR	Net IRR	Gross IRR	Net IRR
Debt[i]	3.3%	2.4%	2.4%	2.1%	3.2%	2.3%
Equity[ii]	31.9%	28.2%	13.1%	10.4%	27.9%	24.5%

Notes: (i) The IRR on debt operations takes account of interest receipts and fees, direct costs, capital disbursements and repayments. No adjustment has been made for specific or general loan loss provisions, but see Section 4.4.2 for comments on the notional effect of provisioning in the Bank's profitability model.
(ii) The IRR on equity investments takes account of realised gains and dividends, assumed equity cost of funds of around 5 per cent, direct costs, capital flows (equity subscriptions and repayments),

[10] Annex 7 explains how the efficacy and transition impact ratings tables have been compiled.
[11] Net return in table 8 is after allowance for direct costs, but before provisions.

impairment losses on completed investments and unrealised gains and losses based on fair value at December 2005.

The table invites a number of comments, first on debt returns and then on the returns on equity investments, as follows.

4.4.2 Returns on debt operations

In order to test the rationality of the results obtained in respect of returns on debt operations, the evaluation team calculated the weighted average margin on debt operations in the sample of 101 projects used in this study. The weighted average margin on this basis was 2.0 per cent. An overall net return of 2.3 per cent therefore appears reasonable, after allowing for fee income receipts and direct costs. In calculating the returns, as noted above, the evaluation team applied the Bank's profitability model, which is used on a project-by-project basis during project preparation.

The model calculates the projected IRR, which is reported in Board documents as the expected contribution of the project to the Bank's profitability. While the evaluation team used the model to estimate net (after direct costs) return on investment, the exercise also resulted in figures produced by the model for net return on investment for *active* debt operations *after provisions*.[12] The model automatically applied specific and general provisions that resulted in a notional negative net return of -0.6 per cent. This result calls to mind the concerns expressed recently that the Bank's profitability model might lack sophistication in the way in which it estimates provisions, or risk adjustments.

The evaluation team understands that a number of refinements are being made to the risk adjustment approach in the model so that ex-ante projections of profitability will reflect the Bank's actual experience more closely. The evaluation team acknowledges that this issue extends beyond FI operations to other industry sectors and welcomes the proposed refinements to the model.

4.4.3 Returns on equity investments

It should be noted that the figures here are based on both returns from equity funds and returns from direct equity investments by the Bank in other FIs. Active investments include unrealised investments at December 2005 and therefore include a number of highly profitable investments that were realised in the course of 2006. The combined IRR of 24.5 per cent (December 2005) reflects the results of 'fair value' accounting applied to all investments held at that date.

It is important to note that the calculations contain no general provisions for future risks or fall in value. Such provisions would not be acceptable under the 'fair value' methodology. However, it may be prudent, when making projections for internal management purposes, to apply a set of country or region-specific discount factors in estimating future returns.

4.4.4 Efficiency rating

This section considers to what extent the Bank was able to execute its financial sector activities in a cost effective manner. In other words, did the Bank make or lose money from these activities and create value for its shareholders, irrespective of the other considerations (relevance, efficacy and impact) that are addressed in this study?

[12] Actual booked costs were input rather than the standard estimates of costs used during project preparation.

The evaluation team's calculations show a gross internal rate of return on the Bank's FI debt operations of about 3.2 per cent versus about 3.5 per cent for the Bank's overall debt portfolio. The gross return on the FI equity portfolio is estimated at around 27.9 per cent compared with about 8.4 per cent for the Bank's overall equity portfolio. The returns on the equity portfolio clearly outstrip returns on the loan book.

As noted above, the Bank made a number of highly profitable exits in 2006, and some of the financial benefit will have been anticipated in the fair values recorded in the books as at December 2005. While the return on the FI debt portfolio appears to be lower than the return on the Bank's overall debt portfolio, the evaluation team considers that on balance an efficiency rating of "Excellent" is warranted because of the high level of profitability of the Bank's equity investments in the financial sector.

4.5 Transition impact

Table 9, which shows the average transition impact rating for operations in the sample, provides a measure of the impact of the 1999 FSOP as realised through the Bank's investment projects. The analysis is supplemented by comparing the results with the remaining transition challenges identified in the Bank's 2005 TIR and by looking also at the reported achievements of policy dialogue in the financial sector.

Table 9: Transition impact of sample investment projects[13]

TI category TI indicator	**No. of FSOP objectives**	**No. of projects addressing objectives**	**Average transition impact rating**
Structure and extent of markets	***4***	***96***	***2.32***
Competition	2	58	2.35
Market expansion	2	86	2.31
Market-supporting inst'ns and policies	***3***	***33***	***2.37***
Private ownership	2	26	2.58
Frameworks for markets	1	9	1.78
Market-based behaviour	***5***	***66***	***2.17***
Skill transfer	1	29	2.10
Demonstration effects	1	20	2.10
Improved standards	3	55	2.21
Overall	***12***	***101***	***2.27***

Note: Rating key: 1 = excellent; 2 = good; 3 = satisfactory; 4 = marginal; 5 = unsatisfactory; 6 = negative.

Table 9 shows an overall average impact rating of close to "Good". Interestingly, both the highest and lowest scores apply to the category "market-supporting institutions and policies". The analysis suggests that the "private ownership" indicator achieved least success while "frameworks for markets" (in practical terms, largely consolidation) scored highest.[14] The

[13] Annex 7 explains how the efficacy and transition impact ratings tables have been compiled.

[14] It may be remarked that a low transition impact score for "private ownership" seems odd given that Bank support for private ownership in the financial sector has been at the forefront of the Bank's policies. However, explicit and specific "private ownership" objectives were identified in only 26 of the 101 projects in the sample. The Bank's efforts to promote private ownership appear to have been relatively more limited in the period from 2000 to 2006 compared with the previous decade. This may in part be explained by the successes achieved in the 1990s with financial sector privatisation in advanced and intermediate transition countries. It should be noted also that the transition impact rating was "Satisfactory" or lower in 11 of the 26 occurrences in the sample of "private ownership" as an objective. This reflects the problematic operational environment of these projects and the difficulty of stimulating private ownership when there is a lack of government commitment. The low number of Bank initiatives combined with the relatively low average performance of individual projects is therefore the source

transition impact ratings of individual operations in the sample range from “Unsatisfactory” (two projects) to “Excellent” (nine projects). The distribution of individual project ratings is as follows:

Table 10: Distribution of transition impact ratings

Transition impact rating	**No. of projects**	**% of projects**
Excellent	9	9
Good	65	64
Satisfactory	15	15
Marginal	10	10
Unsatisfactory	2	2
Negative	na	na
Total	101	100

It can be seen that when assessed at the individual project level, 73 per cent of operations in the sample achieved transition impact ratings of “Excellent” or “Good”. However, when assessed at the operational policy level by relating the results to policy priorities, the outcome is more modest.

For comparative purposes, the evaluation team consulted the TIR of 2001 and 2005 and the 2005 Assessment of Transition Challenges. Table 11 shows (i) the transition impact and (ii) the degree of remaining transition challenges assigned to 27 countries in 2005. The table maps the “degree of remaining transition challenges” against the transition impact rating in 2005 for the banking sub-sector of each country.

Table 11: Transition impact and remaining challenges 2005 – banking

Realised TI (i)	**Degree of remaining transition challenges (ii)**		
	Small	**Medium**	**Large**
Highly significant			
Romania		Romania	
Serbia and Montenegro*			Serbia and Montenegro*
Slovak Republic	Slovak Republic		
Significant			
Bosnia & Herzegovina		Bosnia and Herzegovina	
FYR Macedonia		FYR Macedonia	
Georgia			Georgia
Kazakhstan	Kazakhstan		
Moldova			Moldova
Poland	Poland		
Slovenia	Slovenia		
Moderate			
Armenia		Armenia	
Azerbaijan			Azerbaijan
Belarus			Belarus
Bulgaria	Bulgaria		
Croatia	Croatia		
Czech Republic	Czech Republic		
Kyrgyz Republic		Kyrgyz Republic	
Lithuania	Lithuania		
Russia			Russia
Ukraine		Ukraine	
Minimal			
Albania		Albania	
Estonia	Estonia		
Hungary	Hungary (N)		
Latvia	Latvia		
Tajikistan			Tajikistan
Turkmenistan			Turkmenistan
Uzbekistan			Uzbekistan

Sources: (i) EBRD Transition Impact Retrospective 2, companion paper CS/FO 05-17.
(ii) Assessment of Transition Challenges CS/FO 05-10.

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of a low transition impact rating in the area of private ownership at *sector level*. This does not, of course, recognise some highly visible positive results from certain individual operations at *project level*.

Note: Serbia and Montenegro joined the EBRD in January 2001. They became individual members of the Bank in June 2006.

Some entries in the table require little if any explanation, for example, the minimal impact and large remaining challenges attributed to Tajikistan, Turkmenistan and Uzbekistan. Some other entries reflect the advanced transition stage of a number of countries, for example the minimal impact (between 2000 and 2005) and small remaining challenges in Estonia, Hungary and Latvia.

While there has been moderate impact in Azerbaijan, Belarus and Russia, there remain large challenges in these countries, largely due to the work still to be done on ‘market-supporting institutions and policies’, in particular effective regulation and supervision.[15] Serbia and Montenegro, Georgia and Moldova seem to be extreme cases where the Bank records significant or highly significant impact, but large challenges remain. The following observations on the banking sector in Georgia from the Assessment of Transition Challenges are illustrative:

“The basic regulatory framework is not in place, lacking a deposit insurance system. The secured transactions law is restricted. Banks are small and inefficient, so further consolidation is still pending. Market-based conduct, approached through the domestic credit to private sector/GDP ratio, is low.”

In other words, despite extensive efforts with individual banks (strong results when assessing the institutional development of some banks and a number of investment climate initiatives), large challenges remain at the sectoral level. Similar observations are made in the Assessment of Transition Challenges paper in respect of a number of other countries.

It is instructive also to juxtapose the country transition impact ratings assigned in the 2001 TIR with those in the 2005 TIR, as in Table 12 for the banking sub-sector.

[15] It is noteworthy that there has been strong official resistance to bank privatisation in Azerbaijan, Belarus and Russia. According to the EBRD Transition Report 2006 the asset share of state-owned banks is around 55 per cent in Azerbaijan and 75 per cent in Belarus. A recent paper on the Russian banking system by FitchRatings notes that the three largest state-owned banks (Sberbank, Vneshtorgbank and Gazprombank) account for about 40 per cent of total assets. (“Russian Banking System and Prudential Regulations”, FitchRatings Country Report, 16 July 2007.)

Table 12: Country transition impact ratings, banking, 2005 and 2001 TIR

Country	2005 TIR				2001 TIR			
TI rating[i]	**V.sig[i]**	**Sig[i]**	**Mod[i]**	**N/Min[i]**	**V.sig[i]**	**Sig[i]**	**Mod[i]**	**N/Min[i]**
Albania				X	X			
Armenia			X					X
Azerbaijan			X					X
Belarus			X				X	
Bosnia & Herzegovina		X			X			
Bulgaria			X			X		
Croatia			X			X		
Czech Republic			X			X		
Estonia				X		X		
FYR Macedonia		X				X		
Georgia		X					X	
Hungary				X	X			
Kazakhstan		X					X	
Kyrgyz Republic			X			X		
Latvia				X		X		
Lithuania			X		X			
Poland		X			X			
Moldova		X				X		
Romania	X					X		
Russian Federation			X					X
Serbia & Montenegro[ii]	X							
Slovak Republic	X					X		
Slovenia		X					X	
Tajikistan				X			X	
Turkmenistan				X				X
Ukraine			X				X	
Uzbekistan				X			X	
Number of countries	*3*	*7*	*10*	*7*	*5*	*10*	*7*	*4*

Notes: (i) Ratings key: V. sig = Very significant; Sig = Significant; Mod = Moderate; N/Min = None/Minimal.
(ii) Serbia and Montenegro joined the Bank in January 2001. Serbia and Montenegro became individual members of the Bank in June 2006.

In 13 cases the 2005 TIR records a lesser degree of impact on the banking sector at the country level than the 2001 TIR, although this could intuitively be expected in eight out of these which are advanced transition or EU accession countries. Of more concern are 5 countries (Albania, Bosnia and Herzegovina, the Kyrgyz Republic, Tajikistan and Uzbekistan) where banking sector development may be hindered by continuing political reluctance to adopt and enforce strong regulation and supervision free of government interference.

In eight cases the 2005 TIR indicates that the Bank was achieving a higher level of impact than in the years to 2001. However, the table suggests that there was “no movement” in five cases, that is the Bank continued to have minimal impact in Turkmenistan, moderate impact in Ukraine and Belarus, and significant impact in FYR Macedonia and Moldova.

On balance, and having regard to the various perspectives afforded by the above analytical approaches, the evaluation team assigns an overall rating of “Good” to the Bank’s impact on the financial sector.

4.6 Overall performance assessment

This section combines the rating of each of the four factors into an overall performance rating as shown in Table 13.

Table 13: Overall sector performance-rating summary

Rating factor	Rating
Relevance	Good
Efficacy	Good
Efficiency	Excellent
Impact	Good
Overall assessment	**Successful**

The review finds that the Bank’s activities in the financial sector have been overall “Successful” because of “Good” relevance and “Good” transition impact and because those activities were conducted with “Good” efficacy and “Excellent” efficiency.

5. Looking forward: challenges ahead

This review of the Bank’s FSOP assesses the achievements and remaining challenges resulting from the Bank’s activities at sectoral level. Annex 6 contains selected lessons from EvD reports on FI operations between 2001 and 2006. The evaluation team considers that the sector-level evaluation provides useful input to strategy development that could not be derived simply by scrutinising individual evaluation reports.

Nevertheless, it is interesting to note that lessons from evaluations in recent years combine to add weight to a principal finding of this study, namely that the Bank should make a more concerted effort to promote investment project objectives that reinforce market-supporting institutions and policies. Lessons derived by EvD have highlighted the importance of transparent shareholding structures and of management structures that provide for adequate checks and balances. In countries where the environment is being reformed only slowly, it is essential for the Bank to work with the authorities to improve the legal, regulatory and supervisory framework of the financial sector.

For example, continuing due diligence is necessary to monitor the beneficial ownership of financial institutions and the possible involvement of politically exposed persons.[16] These steps are essential to building and maintaining confidence in the financial sector.

To sharpen focus on the challenges ahead in the financial sector, in particular the manifest remaining transition challenges facing the Bank and its countries of operations, it is instructive to ask two questions. First, how effective has the Bank’s response to the operational priorities set out in the 1999 FSOP been? Secondly, how well targeted was the 1999 policy with the benefit of hindsight?

The first question has been answered to a large extent by the analysis in Section 4, which concludes with an overall performance rating of “Successful” for the Bank’s interventions in the financial sector, taking account of investment operations and investment climate initiatives. However, it is worth noting that the findings of close to “Good” for efficacy and impact arising from the analysis of the sample of 101 investment operations may appear counterintuitive to some, given that a cursory glance at aggregated ratings for individual projects in the sample could perhaps suggest a higher overall rating.

[16] EvD’s Annual Evaluation Overview Report for 2007 contains a chapter on “Integrity in Bank Operations” in which these issues are addressed more generally with regard to EBRD operations. (BDS07-152, approved by the Board on 24 July 2007).

The present study, which has mapped operational results to the priorities outlined in the 1999 FSOP, shows that achievements at the sector level have not had the degree of combined impact that might be assumed simply by aggregating individual project scores. Perhaps the most significant factor influencing this outcome emerges from the analysis in Section 4.2 above of the relevance of the Bank's financial sector interventions.

While relevance is rated "Excellent" with regard to "structure and extent of markets" and "Good" in respect of "market-based behaviour", the findings of the analysis support only a "Satisfactory" rating as regards "market-supporting institutions and policies".

How well targeted, then, was the 1999 policy document? As discussed in Section 1 of the study, the 1999 FSOP announced itself as a refocused operational policy taking a more systemic view. With the benefit of hindsight, this appears to have been a well-considered approach in response to transition achievements in the 1990s and in reaction to the 1998 Russian crisis. The 1999 policy introduced sustainability as a key goal of the Bank's interventions in addition to the financial deepening that had been the main focus of the 1996 policy.

Sustainability was (and is) to be promoted by building confidence and competition in the financial sector. Confidence was (and is) advanced by establishing market-oriented financial institutions. This entails disengaging the state from financial sector operations, including the ownership of banks, while simultaneously reinforcing the state in the sense of creating sound legal, regulatory and supervisory frameworks. In the evaluation team's view the targeting of the 1999 policy was sound because it struck a good balance of the three transition components: "structure and extent of markets", "market-supporting institutions and policies", and "market-based behaviour".

In the language of transition impact developed by the Bank, confidence-building and sustainability are stimulated by interventions that promote market-supporting institutions and policies and market-based behaviour, while financial deepening is achieved by targeting the structure and extent of markets through encouraging competition and market expansion. The present study has found that the Bank's interventions through investment operations since 2000 focused rather more on the structure and extent of markets (through promoting competition and market expansion) and market-based behaviour (through skills transfer, improved governance and demonstration effects) than on market-supporting institutions and policies.[17]

Looking ahead, the Bank will have to challenge the lack of political will that persists in a number of countries to drive through the reforms needed to underpin a sustainable financial sector. As well as contributing through its legal transition initiatives to the development of a sound legal framework, the Bank can do (and has done) much to support the development of technical competence in the fields of regulation and supervision. However, these efforts will be fruitful in the long term only when they have political support in the country.

One may cite the example in the mid 1990s of the Kyrgyz Republic where, in the experience of the evaluation team, serious attempts were made to acquire the technical skills necessary for banking supervision. The results, however, in terms of systemic impact, were not immediately observable. The implementation and enforcement of regulation were hindered by lack of support within government.

It is important to acknowledge the major shifts that have taken place in the Bank's financial sector operations since the 1999 FSOP. The charts and tables in Section 3 of this study illustrate

[17] See Table 1 and Annex 1.

clearly that business in central Europe and the Baltic states is falling away in relative volume terms, representing 27 per cent of the portfolio at December 2006. At the same time, the Russian portfolio has risen to around 27 per cent although, according to the 2001 TIR, the Bank had "minimal" impact in Russia in the period to 2001 and, according to the 2005 TIR, only "moderate" impact in the intervening years.

At the same time, the remaining transition challenges in Russia are assessed to be "large". Also as assessed by the 2005 TIR, the Bank had only "moderate" impact in Armenia, Azerbaijan, Belarus, the Kyrgyz Republic and Ukraine; and "minimal" impact in Albania, Tajikistan, Turkmenistan and Uzbekistan.

On a more positive note, there has been a significant rise in business with non-bank financial institutions, which has been the fastest growing segment of FI business in recent years and now represents around 17 per cent of the FI portfolio. A good degree of higher level institutional, legislative and regulatory development will be required to underpin expansion of FI business across all segments.

6. Recommendations

While the EBRD should take credit for its contribution to the transformation of the financial sector in the EU accession countries, it is clear that some countries of operations have made much less progress along the transition path. Lessons from OPERs and EvD special studies in recent years confirm the continuing need for Bank support to increase confidence in the financial sector and to increase financial deepening.

This study concludes with the following recommendations aimed at further enhancing the effectiveness of the Bank's financial sector operations policy. In particular, the evaluation team considers that future policy would benefit from a refocusing of priorities to target remaining transition challenges, from stronger linkages between policy priorities and investment climate initiatives, and from stronger linkages between policy dialogue and project objectives in the implementation of policy.

Clearly focused policy priorities

At the commencement of the present review, the evaluation team extracted the investment project and investment climate-related objectives from the 1999 policy document. While the document was sufficiently clear to allow the priorities to be identified, their presentation in the policy document might be regarded as somewhat diffuse which could lead to a loss of focus in implementation over time.

Future statements of policy should relate strategic priorities clearly to transition challenges and transition gaps. An indication of strategic targets should be given to enable progress to be assessed periodically and policy refinements to be adopted in the light of experience.

Political support for financial sector reforms

Countries must build the technical capacity for financial sector regulation and supervision. Efforts in this direction will only succeed with in-country political backing. The Bank should consider means of structuring policy dialogue to emphasise to governments where necessary the benefits that will accrue to all stakeholders from building confidence in a privately owned financial sector.

Future policy should re-emphasise the importance of market-supporting institutions and policies

The 1999 FSOP stressed the importance of encouraging the development of sustainable financial systems though increasing the role of market processes. In the evaluation team’s view, the 1999 FSOP targeted principally “market supporting institutions and policies”, followed equally by “structure and extent of markets” and “market-based behaviour”. A conclusion of this study is that, from the sectoral perspective, the implementation of the policy has focused more on the latter two transition categories, certainly as concerns the objectives of investment operations.

This translates into a focus on competition, market expansion and institution building which has contributed strongly to the ongoing transition process in those countries that already have sufficient market-supporting institutions and policies in place. A challenge facing the Bank is to design investment operations in such a way as to stimulate and encourage the development of sound legal, regulatory and supervisory frameworks in countries where these are still lacking.

Seek to integrate policy dialogue initiatives and market-supporting TC initiatives in the design of investment operations where possible

As noted in the 1999 FSOP (Section 3.1): “The key to achieving a well functioning and stable financial system is to strengthen market mechanisms and initiatives and to support them with effective financial laws and regulations.” The FI group has achieved notable successes in stimulating institutional change at corporate level through carefully designed TC-supported institutional development programmes.

Continuing investment climate and policy dialogue initiatives are necessary to prepare the regulatory and legislative infrastructure for sound banking systems in the early transition countries and for the development of capital markets and non-bank financial institutions in many intermediate and some advanced transition countries. With this in mind, a new financial sector policy should seek to coordinate investment operations as closely as possible with initiatives to develop market-supporting institutions and policies.

For example, in developing financial sector framework facilities for countries or regions, banking teams should describe the precise nature of remaining institutional, regulatory and legislative challenges and identify opportunities for policy dialogue initiatives to contribute to the solution of those challenges.

Coordination with other IFIs

It is clear from the present study that, in spite of the Bank’s significant achievements in stimulating the development of market-based financial institutions, significant challenges remain in a number of countries of operations. Given the magnitude of the task, the Bank should consider instituting formal and regular consultations with other international financial institutions (IFIs) in order to reach common ground on approaches to overcome resistance to privatisation, develop sound prudential supervision and improve governance.

Going forward, the Bank’s financial sector policy should address opportunities for concerted initiatives with other IFIs to maximise the effectiveness of the Bank’s investment operations and policy dialogue. A new operations policy for the financial sector should set out a strategic approach to the Bank’s cooperation with other IFIs.

The Bank should tailor interventions fully to initial country conditions when designing financial sector operations

In early transition economies, prerequisites for successful EBRD operations may include basic financial sector reforms such as exchange rate reunification, liberalisation of the payment system, stronger financial sector supervision, improved financial reporting and auditing, and the stimulation of minimally functioning money and capital markets. To the extent that sector-wide constraints have not been relieved by EBRD policy dialogue or other IFI initiatives, the Bank should review carefully the potential impact of these constraints on project outcomes and define project objectives accordingly.

Funding technical cooperation initiatives

EBRD has made substantial overall returns from its financial sector interventions. The Bank should consider allocating a portion of the moneys earned to fund TC initiatives including legal transition and policy dialogue. The establishment of a TC fund from the Bank's profits to be administered by the Bank would facilitate the structured use of technical assistance in project design and implementation and enable the Bank to strengthen linkages between TC operations and investment projects.

In the case of beneficiaries who are better established financially, the use of a TC pool funded by the Bank would make it more feasible to request beneficiaries to make a contribution to costs where appropriate. EvD welcomes the discussions that have been held recently between the Board and EBRD management on expanding further the scope for TC internalisation with a view to meeting, from the Bank's budget, the costs of certain operational activities and investment climate initiatives currently funded by donors.

Estimating financial returns from operations

The Bank's move southwards and eastwards is likely to result in a larger number of lower volume financial sector operations. Investments in these countries may have higher project preparation and execution costs and may entail more detailed monitoring during implementation.

As discussed in Section 4.4.2 above, the project profitability model employed at present by the Bank shows a very low or negative projected return after risk adjustment in a significant number of cases. The Bank's actual experience to date is rather more positive. While it is prudent and necessary to capture likely costs in the model on a reasonable basis, there is a danger that otherwise good projects may be rejected at the appraisal stage or by the Board if projected profitability is distorted by risk adjustments that are not realistically based.

The Bank's operating results suggest that the initiative currently under way to refine the risk adjustment mechanism in the project profitability model in order to align it more closely to actual experience is to be welcomed. Nevertheless, in future cases where project contribution after risk adjustment is anticipated to be low or negative, it will remain important to weigh the projected return against transition and market pricing considerations.

ANNEX 1

1999 Financial Sector Operations Policy – transition impact indicators and related policy objectives

Macro transition indicators	**Transition impact indicators**	**Financial sector policy objectives** **Investment projects**	 **Investment climate initiatives**
Structure and extent of markets	1. Competition	1.1 Add to the alternative sources of financing 1.2 Promote efficiency and client orientation to increase competition	Promote confidence and competition in an independent financial system free of arbitrary government influence and business capture
	2. Market expansion	2.1 Extend financial sector coverage to new types of customer, especially private sector and MSMEs 2.2 Broaden range of providers of financial instruments (banks, non-banks and specialised institutions)	
Market-supporting institutions and policies	3. Private ownership	3.1 Strengthen commercial orientation of state-owned FIs through restructuring and privatisation 3.2 Facilitate foreign direct investment	Effective prudential regulation and supervision of banks and non-bank FIs
	4. Frameworks for markets	4.1 Consolidation of financial institutions through mergers and liquidation	Improving legal and institutional arrangements for resolution of failed FIs Acceptable accounting and auditing practices Support for legal transition to upgrade legislative system governing secured transactions
Market-based behaviour	5. Skills transfer	5.1 Transfer skills and technology to local FIs	
	6. Demonstration effects	6.1 Broaden geographical coverage of the financial sector; support expansion of local institutions that have performed well	
	7. New standards for business conduct	7.1 Improve governance through participation in boards 7.2 Strengthen business practices of local FIs 7.3 Improve transparency and disclosure standards	

ANNEX 2

Number of projects per country / sub-sector per year[1]

Country Name / Year	91	92	93	94	95	96	97	98	99	00	01	02	03	04	05	06	Total
<REGIONAL>	-	1	4	4	3	3	5	3	3	10	5	4	5	9	6	6	71
ALBANIA	-	-	-	1	-	1	-	1	1	1	-	-	1	-	-	-	6
ARMENIA	-	-	-	-	-	-	-	-	-	1	-	-	-	1	2	1	5
AZERBAIJAN	-	-	-	-	-	-	-	1	-	-	-	-	1	-	4	4	10
BELARUS	-	-	-	1	-	-	-	1	-	-	-	-	1	1	1	-	5
BOSNIA AND HERZEGOVINA	-	-	-	-	-	-	2	1	1	-	1	2	1	1	-	1	10
BULGARIA	-	-	1	3	2	1	5	-	3	2	-	1	4	1	1	1	25
CROATIA	-	-	-	-	4	5	2	3	1	2	2	3	2	1	-	1	26
CZECH REPUBLIC	-	-	-	-	2	-	2	2	1	-	-	-	1	-	-	-	8
ESTONIA	-	-	-	3	3	4	7	5	1	1	-	1	-	-	-	-	25
FYR MACEDONIA	-	-	-	1	1	1	-	1	2	1	-	1	-	2	-	2	12
GEORGIA	-	-	-	-	-	1	2	1	-	-	-	-	3	-	6	6	19
HUNGARY	-	-	5	3	3	4	4	-	1	-	1	-	1	-	-	-	22
KAZAKHSTAN	-	-	1	-	-	-	1	1	-	1	2	3	7	1	5	3	25
KYRGYZ REPUBLIC	-	-	-	-	1	1	-	1	-	-	1	-	1	-	2	-	7
LATVIA	-	-	-	1	3	4	2	1	2	-	1	-	-	-	1	-	15
LITHUANIA	-	-	-	1	3	2	-	3	2	1	1	-	-	-	2	2	17
MOLDOVA	-	-	-	-	2	-	1	1	1	-	1	1	1	3	2	1	14
MONTENEGRO	-	-	-	-	-	-	-	-	-	-	-	2	-	-	-	-	2
POLAND	1	1	3	5	3	4	2	4	3	6	4	2	-	2	-	1	41
ROMANIA	-	1	3	4	2	2	2	2	1	-	1	-	8	3	3	3	35
RUSSIA	-	-	1	4	11	11	8	3	1	3	1	6	3	19	19	20	110
SERBIA	-	-	-	-	-	-	-	-	-	-	1	3	4	2	-	2	12
SLOVAK REPUBLIC	-	-	2	-	3	3	2	1	-	-	3	2	1	-	-	-	17
SLOVENIA	-	-	-	3	2	-	-	-	1	-	-	1	1	-	-	-	8
TAJIKISTAN	-	-	-	-	-	1	-	-	1	-	-	-	-	-	1	-	3
TURKMENISTAN	-	-	-	1	-	-	-	-	-	-	-	-	-	-	-	-	1
UKRAINE	-	-	1	1	3	-	-	3	2	2	-	-	2	1	2	6	23
UZBEKISTAN	-	-	1	-	1	3	-	-	-	1	-	-	-	-	-	-	6
Total	**1**	**3**	**22**	**36**	**52**	**51**	**47**	**39**	**28**	**32**	**25**	**32**	**48**	**47**	**57**	**60**	**580**

Source: EBRD Data Warehouse

Note: The table shows number of projects per country per year (excluding microfinance)

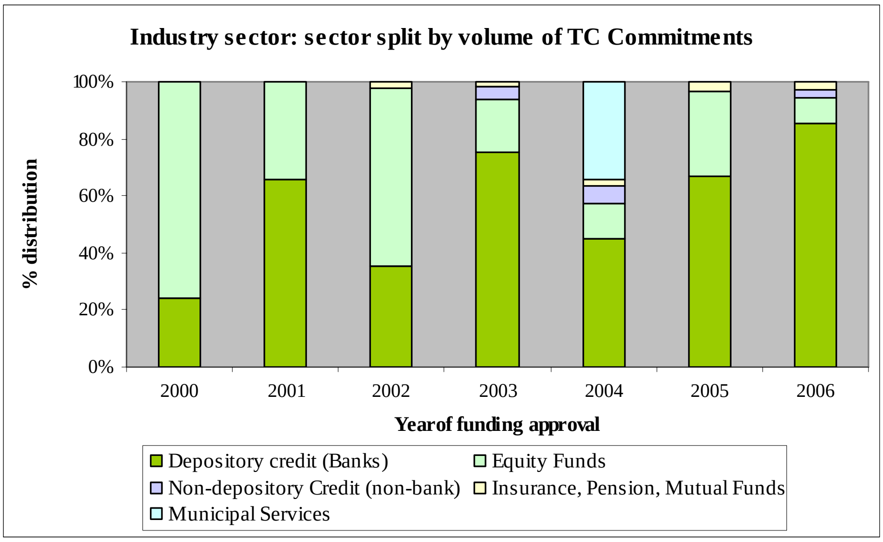
Table: Number of projects per sub-sector per year (excluding microfinance)

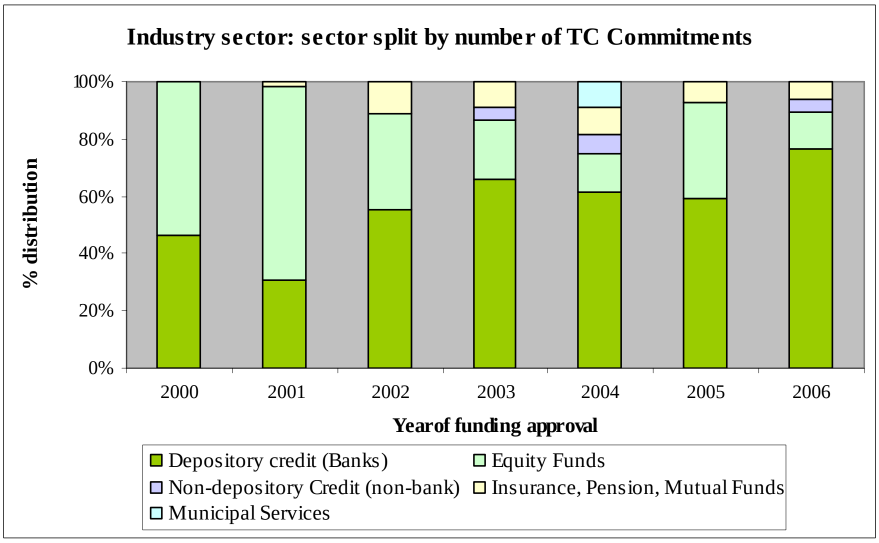
Sub-sector / Year	91	92	93	94	95	96	97	98	99	00	01	02	03	04	05	06	Total
Bank equity	-	-	7	10	9	12	17	16	8	8	7	9	8	8	12	15	146
Bank lending	1	1	8	15	23	28	13	16	10	12	7	11	27	28	29	26	255
Equity funds	-	2	5	9	14	10	15	7	6	7	4	5	3	5	7	7	106
Non-bank FI	-	-	2	2	6	1	2	-	4	5	7	7	10	6	9	12	73
Total	**1**	**3**	**22**	**36**	**52**	**51**	**47**	**39**	**28**	**32**	**25**	**32**	**48**	**47**	**57**	**60**	**580**

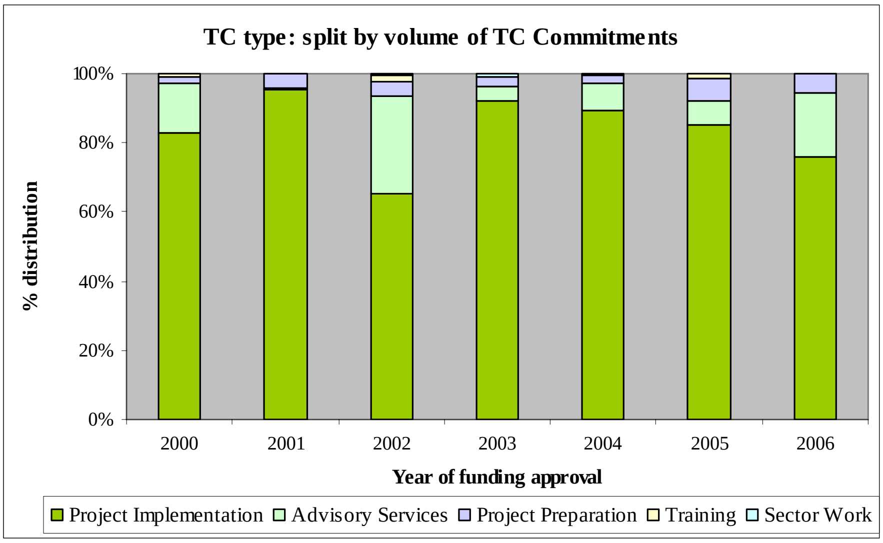
Source: EBRD Data Warehouse

[1] For the purpose of this study, each standalone operation and each framework is counted as a project.

TC operations in the financial sector 2000-06



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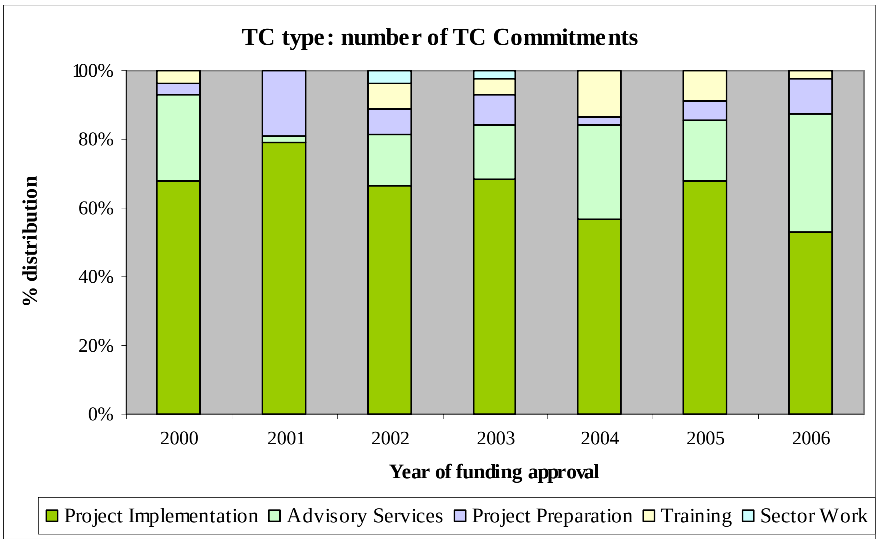
100%
80%
60%
40%
20%
0%
% distribution
2000
2001
2002
2003
2004
2005
2006
Year of funding approval
Project Implementation
Advisory Services
Project Preparation
Training
Sector Work


TC type: number of TC Commitments
100%
80%
60%
40%
20%
0%
% distribution
2000
2001
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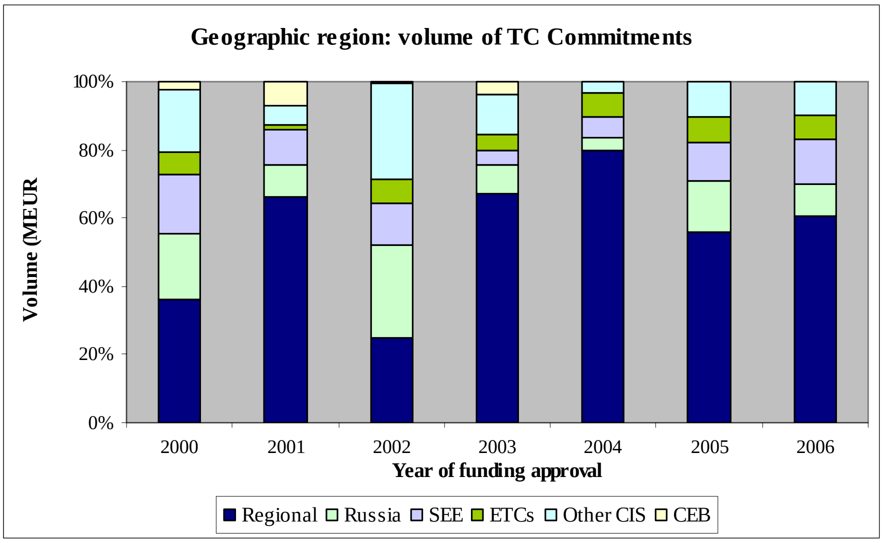
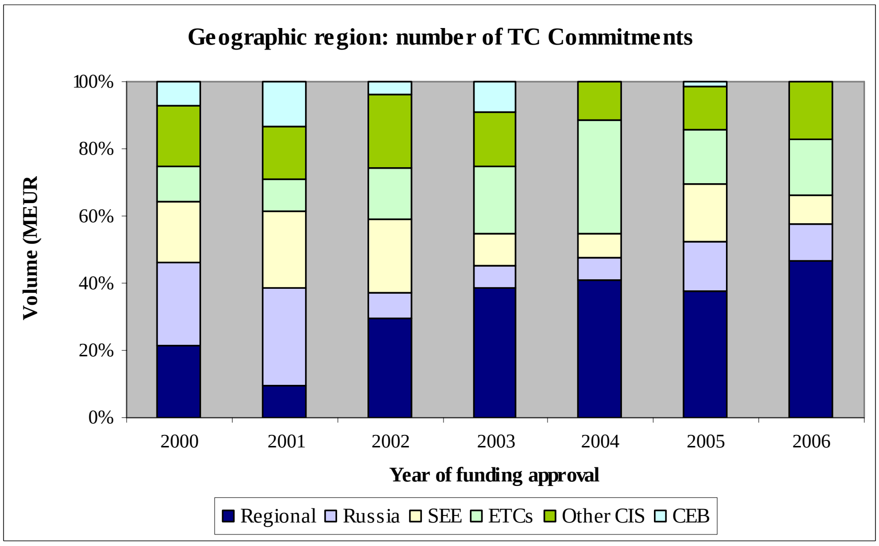
2004
2005
2006
Year of funding approval
Project Implementation
Advisory Services
Project Preparation
Training
Sector Work


Geographic region: volume of TC Commitments
Volume (MEUR
100%
80%
60%
40%
20%
0%
2000
2001
2002
2003
2004
2005
2006
Year of funding approval
Regional
Russia
SEE
ETCs
Other CIS
CEB


Geographic region: number of TC Commitments
Volume (MEUR
100%
80%
60%
40%
20%
0%
2000
2001
2002
2003
2004
2005
2006
Year of funding approval
Regional
Russia
SEE
ETCs
Other CIS
CEB

Number and frequency of occurrences of project-level objectives mapped to policy priorities

As a rule, Board documents identify three or four objectives for a project at approval. The evaluation team counted 345 project-level objectives across the evaluation sample.[2] The evaluation team then mapped each of the 345 project-level objectives to one of the 12 policy objectives and by this means to a transition indicator and a transition category. The results of the mapping are shown in the following tables.

Table: Number and frequency of occurrences of project-level objectives mapped to policy objectives

TI category TI indicator	No. of FSOP objectives	No. of occurrences of objectives	% frequency of occurrences
Structure and extent of markets	***4***	***185***	***54***
Competition	2	62	18
Market expansion	2	123	36
Market-supporting institutions and policies	***3***	***35***	***10***
Private ownership	2	26	7
Frameworks for markets	1	9	3
Market-based behaviour	***5***	***125***	***36***
Skill transfer	1	29	8
Demonstration effects	1	20	6
Improved standards	3	76	22
	12	***345***	***100***

The table shows the frequency of occurrences of project-level objectives as they relate to TI indicators and categories for the 101 operations in the evaluation sample. Of the 345 occurrences, 54 per cent relate to ‘structure and extent of markets’, 36 per cent to ‘market-based behaviour’ and 10per cent to ‘market-supporting institutions and policies’. This suggests that, through its financial sector operations, the Bank focused principally on FSOP objectives targeting market expansion and competition.

At the same time, market expansion objectives occurred twice as frequently as competition objectives. In some 36 per cent of occurrences the project-level objectives at approval targeted market-based behaviour, mainly through improved standards, but also through skill transfer and demonstration effects. There was a lesser frequency of objectives, around 10 per cent, targeting market-supporting institutions and policies through private ownership and frameworks for markets.

[2] This is the number of occurrences of project-level objectives in Board documents for the operations in the sample. Many project-level objectives, of course, recur frequently, for example: “Support the business growth of …” (a market-expansion objective); “Strengthen the institutional capacity of …” (a skills transfer objective).

ANNEX 6

SELECTED LESSONS FROM EVD OPERS AND SPECIAL STUDIES ON FINANCIAL INSTITUTION OPERATIONS 2001-06

ABBREVIATIONS

FI	Financial institution
MPF	Multi-project facility
OGC	Office of the General Counsel
OPER	Operation performance evaluation review
PB	Participating bank
PED	Project Evaluation Department
SMEs	Small and medium-sized enterprises
TC	Technical cooperation

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Selected lessons from PED OPER reports on financial institution operations 2001-06

1. Transition impact and additionality

Transition impact can be heightened when the Bank responds proactively to changes in circumstances. Unexpected changes may occur at the micro or macro level, requiring a swift response and flexible approach from the Bank. The Bank can consolidate its position with the client, secure a more effective project and improve earnings by seeking realistic ways to adjust project design, based on altered risk perceptions, when external factors change significantly.

The selective use of waivers can enhance transition impact. Extreme caution must be exercised before granting significant waivers. However, in particular circumstances, the granting of a waiver on condition that the underlying fault will be rectified can allow a project to proceed. It also facilitates the release of transition benefits and helps strengthen the relationship with the client. In such instances, client compliance with undertakings given must be monitored carefully.

Some compromise of commercial interests and the acceptance of higher risk may be necessary at times to achieve the best transition impact potential. In the present case an early sell-down so soon after entry of the strategic investor could well have misrepresented the Bank's intention in the view of both, the strategic investor and the market. A poorly timed sell-down could have destabilised the client's ongoing restructuring efforts and resulted in decreasing value of the Bank's stake. The transition impact potential of the investment was enhanced by the decision to delay a sell-down.

By continuing to work with existing clients during periods of economic uncertainty, the Bank can preserve and increase transition impact. Subject to meeting the Bank's credit requirements, such operations can achieve increased impact both through enhanced institution building and by making funds available for on-lending to the real sector in difficult times.

Vendor-linked leasing spurs the creation of a network facilitiating the flow of information, money and materials between firm and supplier (transition impact). Teaming with vendors, such as motor vehicle and construction equipment dealers, is an important factor for success in the leasing industry. Firms that partner with leading vendors require more focused strategies and operations than those that do not, increasing chances for successful rapid growth and sustainability.

Small equity transactions may produce significant transition impact in conditions of extreme economic and political uncertainty. Where the Bank is able to support existing institutions with direct experience of the local market, this can have an immediate impact on local enterprises in the real sector as well as improving the quality of the local intermediary's loan portfolio. The Bank should continue to seek out local financial institutions that demonstrate the capacity to grow into sound banks.

A proactive and flexible approach to project structuring helps the EBRD build strong relationships. By being proactive, the Bank can propose appropriate measures to mitigate risks as they are identified. This reinforces relationships with clients and partners and can lead to greater profitability and repeat business. In times of political and economic uncertainty and nervousness among foreign investors, the Bank remains highly additional through continuing to support sound institutions.

2. Corporate governance

Management structures have to provide for adequate checks and balances. These are unlikely to be present when one governing body serves simultaneously as supervisory board and investment committee, as in this project. The principle of adequate segregation of functions must be applied throughout the organisational structure to ensure sound governance and control.

Fund managers must have the requisite skills and experience to operate commercially within the host country, and appropriate staff has to be retained. The Bank should not enter a fund unless satisfied with the quality of the fund managers. In assessing the suitability of fund managers, the Bank must also ensure that staff are effectively supervised, and that the compensation structure is adequate to attract and retain experienced, well qualified personnel.

Insurance and pensions-selling practices need to be monitored. In a situation where insurance supervision is developing and consumer protection is negligible, it is imperative that market practices of companies are monitored by means of ongoing market intelligence at local level. This will assist EBRD representatives at supervisory board level to influence responses to incorrect practices where they may exist.

Politically exposed persons (PEPs) require appropriate acknolwedgement in relation to the EBRD's equity investments in banks. When the EBRD invests in the equity of financial institutions, it should take care to identify and seek approval of its partnership with PEPs who may be large shareholders of the financial institution or of its ultimate owners, or who may become related parties through transactions that take place during the EBRD's relationship with the financial institution.

This requires continuing due diligence into the beneficial ownership of the financial institution and monitoring of transactions carried out by it or its major shareholders that may put it into partnership with such persons. The EBRD should include covenants and representations in its project documents that discourage transactions with PEPs by the financial institution.

3. Project appraisal

Focused due diligence enquiries give the Bank additional credit comfort. When experienced Bank staff direct the due diligence process, the results can be used constructively in project design to heighten the transition impact of the project by encouraging the client to adopt best practice. The process can also be an effective learning tool for clients, their management teams and business partners, helping them to understand principles of sound banking as well as introducing them to international standards of disclosure.

A reform-oriented management in a financial institution is a key factor for the successful achievement of objectives related to institutional building. Entry negotiations are fundamental to make sure that such reform-oriented management exists or that an adequate manager can or will be hired. It is difficult to retrospectively change an "old guard" who may have the support of the shareholders or certain political circles.

Carefully assess the suitability of equity finance and avoid its use in cases where debt finance is more appropriate. In early and intermediate transition countries, where the conditions of the banking sector are not friendly or conducive to lending, the Bank should work with the authorities to bring about the changes necessary to create a facilitating environment that will encourage intermediation. In such conditions, it should not be assumed that equity finance is an effective substitute for debt.

Before taking an equity stake in an owner-managed SME, fund managers must establish that the owner understands and accepts the implications of shared ownership, and that the underlying business has the growth potential to provide adequate returns to reward both the fund and the original owners.

If the Bank is buying into an existing fund, it must ensure that the fund manager performed full commercial due diligence on investments in the existing portfolio. In order to assess the risks inherent in the portfolio into which it is buying, the Bank must be certain that the fund managers acted prudently in the selection of investments. The Bank should consider performing its own due diligence on the existing portfolio unless the fund can demonstrate that it has followed sound investment guidelines.

The use of expert consultants in the due diligence process is recommended. It is appropriate to use expert consultants to perform specialised aspects of due diligence. In the present case specialist consultants were employed to carry out integrity checks and to audit the performance and capacity of the client's IT systems and credit scoring technology. While the principle must be observed that it is the Bank's responsibility to appraise the findings of consultants and auditors critically, the careful use of inputs from expert consultants can give the EBRD additional credit comfort and contribute to project design and functioning.

The capacity of local management to adopt and implement good practices is a key determinant of transition impact. During project appraisal and structuring, the EBRD should assess a potential partner bank's willingness to promote broad ownership and transparency as well as its effectiveness in the market. Such an approach helps ensure that project objectives can be achieved with potential to have significant demonstration effect.

The EBRD should ensure that partner banks possess and maintain the skills necessary to operate a credit line for on-lending successfully. In the Bank's experience, successful SME lending projects with new partners have, as a rule, involved some level of technical assistance to improve lending skills. When considering the suitability of a partner bank for an SME credit line, the Bank should analyse the skills level of the potential partner, the capacity of its distribution channel, back office functions and portfolio monitoring procedures. State-owned development banks may lack the necessary attributes and are likely to require extensive capacity building.

4. Project structuring

Risk-mitigation instruments for banking sector projects must be structured with due cognisance of international regulations. The Bank should act on the assumption that the regulatory authorities in countries of operations are working toward the adoption of international standards. If the Bank relies on a local standard that is less rigorous than the international norm, its intentions may be thwarted at relatively short notice by developments in local laws and regulations.

Project agreements should include provisions for the Bank to take necessary actions in the event of poor performance by fund managers. The Bank must have recourse to remedies required to protect its investments. Where appropriate, shareholders' agreements and agreements with other parties should include mechanisms enabling the Bank to rectify the adverse consequences of underperformance. In the present case, the not-for-profit status of the Bank's partners should have alerted the Bank to the possibility that the other shareholders would not give priority to the financial performance of the fund.

Outreach should be strengthened through appropriate conditions in the loan agreement would with the partner bank. The Bank should attempt to include conditions in the loan agreement that encourage the partner bank to achieve a deep penetration of the SME sector. One such requirement could limit the percentage of sub-borrowers in the established client base of the partner bank and prohibit the use of proceeds in refinancing exisiting debt.

Making provision for liquidity sweeps in loan agreements to banking sector intermediaries can mitigate the risk of Bank funds being used for unapproved purposes. The utilisation of Bank funds to enhance a local bank's liquidity position or purchase non-loan assets increases credit and reputational risk for the Bank. The Bank should ensure that liquidity sweeps are included in loan documentation in high-risk environments. This allows the use of repayments by sub-borrowers that are not recycled to amortise the Bank's loan if necessary. Such provision is particularly important where, as in the present case, the term of the Bank's loans significantly exceeds the tenor of sub-loans.

Financial and operational covenants should be designed on a case-by-case basis to encourage the development of sound banking practices over time. As in this case, the careful design of covenants on such matters as portfolio concentration, related party lending limits and prudential ratios, can improve local management's understanding of banking risks and provide management with a useful additional tool for performance monitoring and business planning.

An appropriately structured put mechanism may serve to confirm official commitment to privatisation. Pre-privatisation equity can increase confidence and help ensure a successful privatisation. In certain circumstances the potential for success can be enhanced by using a put mechanism to reinforce official commitment to the privatisation process.

The structure of the fund requires a sufficient time horizon. Especially in countries at an early or intermediate stage of transition, unexpected delays can occur as a result of political, economic and regulatory developments. Sufficient time must also be allowed for identifying local partners, gaining familiarity with business practices and dealing with various organisational matters. It is important, when structuring a new fund, to ensure the availability of adequate resources to cover the set-up period.

The design of equity funds need to give the Bank sufficient leverage over fund managers and the conduct of investee companies. Structuring a fund to allow the Bank to exercise influence through the supervisory board and investment committee, encourages changes in the business practices of investee companies. This can lead to better transparency and accountability and stronger governance. The Bank's influence can be used to overcome resistance to change in difficult environments.

Loan covenants should be used constructively. Loan covenants can be designed to help focus client attention on strategic goals while ensuring correct utilisation of EBRD funding. In the present case covenants were designed both to encourage the client to maintain its strategic focus and to give comfort to the Bank that the client's management would develop the business in the anticipated direction. The client adhered to the covenants allowing the Bank to disburse the loan in full.

Modifications to project design prior to implementation should be considered carefully. When changes in external circumstances necessitate modifications to project design or structure, careful consideration should be given to the effects of the changes on project implementation. Modifications should be consistent with the original goals and intentions of the project. When considering design modifications, it is important to avoid the introduction of features which may lead to fresh difficulties in project execution.

Successful fund managers in early transition environments need a balanced mix of financial engineering, industrial and commercial management skills. Investee companies frequently need hands-on support to realise their underlying investment potential and prepare them for exit via trade sale or sale to a strategic investor. In order to achieve the necessary turnaround, the fund manager must have the capacity to draw on a range of managerial skills in a number of areas.

Fund managers need to have the capacity and willingness to provide adequately skilled management and staff in the region in which the fund will operate. Language skills are important, but even more important are the ability and willingness to translate sound business practices to the early or intermediate transition environment. Experience has shown that successful fund managers are able to motivate multidisciplinary teams of expatriate and local specialists.

Agreements must provide for comprehensive security for the Bank when introducing new financial products in untested markets. In the present case a package of security measures was put in place since no single form of security was proven to be effective in the market. The measures included a combination of pledged assets, parental guarantees, tight covenant structure and sound collateralisation of sub-loans. The comprehensive security structure helps to mitigate the higher risks associated with long-term lending.

5. Implementation and monitoring

SME programmes require independent assessment of the impact of institutional reform. The Bank could take steps to assess, through independent on-site reviews, the quality of the portfolios and lending policies and processes at each partner bank in order to measure the degree of institutional reform. It could follow best practice of leading international banks that regularly use professionally-led review teams to perform such assessments of their own portfolio and processes.

Wherever reasonable, the Bank should negotiate access to specific information necessary to verify the condition of client balance sheet items on an ongoing basis. This is particularly important where reliance cannot be placed on the conclusions of external auditors because of underdeveloped audit skills in the local environment. While the loan agreements in this case provided for extensive access to information, loan agreements, where appropriate, should provide also for right of access to certain specific information and records in addition to the standard provisions on access.

The scope of the provisions should be determined on a case-by-case basis having regard to the Bank's previous experience in the local environment and any constraints imposed on disclosure by local legislation or regulation. In the present case, for example, such additional provisions could have included requests for:

- details of the loan portfolio including large exposures and related party lending
- access to credit files
- cashbook entries and documentation verifying loan advances and repayments
- documentary evidence of interbank transfers to substantiate interbank deposits.

It should be remembered that in some jurisdictions which otherwise do not permit disclosure, access to information is permissible if agreed upon in writing beforehand by the parties.

Strict lending criteria should accompany facilities of the Bank that are designed to open up new markets in countries of operations. In the present case the Bank imposed strict mortgage sub-loan criteria and reporting requirements on the partner bank. Such conditions help ensure that the Bank's funds are properly utilised as intended and in line with established good practice for the type of sub-loan envisaged by the facility. Close ongoing monitoring is required to ensure that the partner bank continues to comply with the agreed conditions.

Capturing information about significant changes in business interests where the Bank client is a key business of an entrepreneur. Prominent shareholders or senior managers of companies in which the Bank has invested may invest personal funds in ventures that, as a consequence, become related to the client company. Even in the absence of business transactions between such entities, there is potential for increased credit and reputational risks to the Bank arising from related party connections.

Operation teams should therefore obtain details of material changes in the business interests of persons holding influential positions in a bank client. These details should then be reported to the credit team annually or semi-annually as part of the regular monitoring process.

6. Technical cooperation

SME programmes require strong commitment from senior and mid-level management of the partner banks and TC packages should be discontinued if commitment fails. Due attention should be paid to monitoring the commitment of the partner bank's management in the early months of an engagement. The Bank must be prepared to terminate the engagement if the management does not comply with previously agreed targets regarding programme development and credit process changes.

While it is not appropriate to press the TC on an unwilling recipient, the Bank should be proactive in assessing a client's training needs and in explaining the benefits to the client. In the present case the TC for training was offered during negotiations but declined by the client who expressed scepticism about the benefits. In retrospect, this scepticism may have been rooted in a lack of confidence rather than a careful analysis of training needs.

Subsequently, the client acknowledged the benefits of training that took place at a later date as part of another operation with the client. These benefits may have accrued earlier if the Bank had presented the case more persuasively with the client when implementing the earlier project.

Where possible, the Bank should seek commitments to provide TC funds for long-term projects from multiple donors. A review of priorities and resulting policy change may affect the availability of TC funds to a project supported by a single donor, potentially jeopardising future operations. Firm long-term commitments from single donors may not be possible for political or budgetary reasons. The Bank should attempt to mitigate the risk to long-term projects by seeking TC commitments from more than one donor.

Financial penalties can help reinforce commitment to achieving objectives. Where possible, include financial penalties for non-performance in pre-privatisation agreements with government bodies. In the present case the government sought to have the financial penalty removed from the memorandum of understanding that set out the conditions of the TC programme.

The Bank insisted on retaining the penalty in order to ensure an appropriate level of commitment to achieving the TC objectives from government agencies and management of the client bank. Such a penalty clause also provides a degree of assurance to donors that parties will work diligently towards achieving stated objectives.

Complex institutional reform programmes require consultants with proven project management skills. In the present case the multifaceted nature of the institutional reform programme called for disciplined management. EBRD staff were required to put in a great deal of effort in the later stages of the programme to redress weaknesses in project management on the part of the consultants. For assignments that require multidisciplinary consulting inputs, the lead consultant should preferably have interim management experience to facilitate implementation with the client.

Institutional reform programmes should be designed to respond to clearly defined client needs. In the present case careful attention was given to the design of the programme to ensure that it was appropriate to the client's needs as assessed by the Bank and agreed with the client. Particularly in early transition countries, it is essential to ensure that such programmes are sufficiently comprehensive and of adequate duration. It is also important that consultants are selected who understand and can work effectively in the difficult local environment.

7. Policy dialogue

Maintaining regular dialogue with different government departments and regulatory bodies is a useful tool in the process of educating legislators and administrators in good practice and business standards. It may not be possible for the Bank to ensure full transparency of operations of local institutions in an environment that generally does not welcome such transparency. Nevertheless the present case demonstrates the value of frequent, ongoing contact and dialogue, both formal and informal, with the authorities. The use of dialogue to convey messages about sound governance and business conduct is a potent catalyst in the transition process.

Lengthy policy dialogue may be required at senior levels of government to overcome local political objections to the privatisation of entities that are regarded as having strategic importance. In the present case senior management of the EBRD have engaged in high-level discussions on the privatisation of the client bank with senior government figures over a number of years. Through a steady process of policy dialogue the Bank can foster privatisation of a strategically important company, securing government commitment to the process while minimising political repercussions.

The EBRD's success depends on successful reform programmes by the countries of operations. It is important to acknowledge the primacy of sound, country-led reform programmes to the EBRD's ability to carry out its mission. A number of countries of operations have not yet taken concrete steps in financial sector reform that would allow the EBRD to assist the transition process successfully through investment operations. In such cases potentially promising EBRD projects may have limited transition impact because of the lack of adequate sector reforms.

It is recommended to start the policy dialogue ahead of the project. In difficult business environments it appears more effective to precede commencement of operation with technical assistance for the policy dialogue while also developing it during project implementation.

8. Environment

Partner banks should be encouraged to consider contracting for environmental services locally to review SME sub-projects. Where appropriate skills and services are available in the local market, some encouragement should be given by the Bank to partner banks in enlisting their services. This would optimise the environmental aspects of sub-borrowers' activities. The Bank, in fostering such an approach, can help partner banks acknowledge the environmental liabilities that may be attached to their SME lending activities. Additional potential benefits include enhanced reputation for the partner bank and sub-borrower and increased profits for the sub-borrower through cleaner production and pollution prevention.

Local environmental regulatory capacity need to be assessed. The EBRD should appraise not only the capacity of the fund manager to adhere to the EBRD's environmental standards but also the capacity of local environmental authorities to enforce environmental laws and regulations. Where capacity is recognised to be weak, the EBRD should consider teaming with other multilateral or bilateral agencies to implement a programme improving local capacity.

Minority equity limitations and enforcement of EBRD bank equity's environmental policy. The environmental policy for bank equity requires that the beneficiary bank apply the policy to all of its activities, not just to certain sub-operations. Where the Bank has had a previous relationship with a bank based on lending, meeting the broader environmental requirements of the equity policy can be challenging. Therefore, banks may need additional specific training in applying the EBRD's environmental procedures in the case of equity investments.

Furthermore, while the Bank's leverage as a minority shareholder may not suffice to achieve rapid broad application of the EBRD's environmental policies, treating all of the EBRD's operations with the client more comprehensively in the context of the full relationship may increase the Bank's leverage to achieve environmental objectives and compliance with EBRD environmental policies.

Methodology – Explanation of the efficacy and transition impact ratings tables (tables 7 and 9 in the main text)

Table 7: Efficacy of sample investment projects

TI category TI indicator	No. of FSOP objectives	No. of projects addressing objectives	Average efficacy rating
Structure and extent of markets	***4***	***96***	***2.28***
Competition	2	58	2.24
Market expansion	2	86	2.29
Market-supporting inst'ns and policies	***3***	***33***	***2.29***
Private ownership	2	26	2.38
Frameworks for markets	1	9	2.00
Market-based behaviour	***5***	***66***	***2.29***
Skill transfer	1	29	2.34
Demonstration effects	1	20	2.20
Improved standards	3	55	2.29
Overall	***12***	***101***	***2.28***

Note: Rating key: 1 = excellent; 2 = good; 3 = satisfactory; 4 = marginal; 5 = unsatisfactory; 6 = highly unsatisfactory.

Table 9: Transition impact of sample investment projects

TI category TI indicator	No. of FSOP objectives	No. of projects addressing objectives	Average transition impact rating
Structure and extent of markets	***4***	***96***	***2.32***
Competition	2	58	2.35
Market expansion	2	86	2.31
Market-supporting inst'ns and policies	***3***	***33***	***2.37***
Private ownership	2	26	2.58
Frameworks for markets	1	9	1.78
Market-based behaviour	***5***	***66***	***2.17***
Skill transfer	1	29	2.10
Demonstration effects	1	20	2.10
Improved standards	3	55	2.21
Overall	***12***	***101***	***2.27***

Note: Rating key: 1 = excellent; 2 = good; 3 = satisfactory; 4 = marginal; 5 = unsatisfactory; 6 = negative.

The first three columns in the above tables replicate Table 5 in Section 4.2.1 of the report's main text and show (1) the standard TI categories and indicators against which the 1999 FSOP has been benchmarked; (2) the number of FSOP objectives addressing each TI category and indicator; (3) the number of projects in the sample addressing the objectives. Column 4 shows the average rating assigned to each of the TI categories and indicators.

By way of illustration, the efficacy ratings were calculated as follows.

- Efficacy is defined as the degree of effectiveness of the financial sector investment operations in the sample.

- "Degree of effectiveness" is measured by taking average ratings scores for "Fulfilment of objectives".
- For this exercise EvD's standard rating scale is graded as follows: 1= excellent; 2= good; 3= satisfactory; 4= marginal; 5= unsatisfactory; 6= highly unsatisfactory.
- There are 101 investment operations in the sample.
- The ratings are mapped to the TI indicators for each operation in the sample (for example, project X, addressing two transition indicators, is rated "Satisfactory" in "Fufilment of objectives" which warrants a score of "3" marked against each of the two indicators).
- The aggregate count of TI indicators (number of occurrences in the sample of 101 operations) is 345.
- The aggregate score (that is, the sum of the scores assigned to the TI indicators on the basis of the fulfilment of objectives ratings) is 787.
- Therefore the average overall efficacy rating for the entire sample is 787/345 = 2.28.

The table of transition impact ratings was compiled in a similar manner.