OPER No: PE08-434S

Operation Performance Evaluation Review
Special Study on the Trade Facilitation Programme (Regional)

Management Comments

The EvD report provides a comprehensive overview of the activities of the Trade Facilitation Programme (TFP) and Management welcomes the opportunity to re-affirm the direction of the Programme over the coming years.

It is important before embarking on a review of TFP to underscore the role that the Programme has played and to understand how it has evolved over time. Trade was recognised at an early stage as a key driver of transition and the Bank has systematically sought to support trade activity in the region. The TFP has been one of the Bank's most successful frameworks, supporting more than 9,000 foreign trade transactions since 1999 and recognised by clients, confirming banks, trade specialists and other IFIs as a flagship for supporting the private sector in Countries of Operation. It is testament to the reputation of the TFP that a number of other IFIs, including IFC, ADB, IDB and AfDB have modelled their own programmes on the EBRD Programme, directly replicating many of its key elements.

After an unsuccessful start in 1994, the TFP was restructured in 1999 to reflect commercial reality and client needs. The Programme has continued to evolve as markets developed and changed. As one of the more commercially driven products offered by EBRD, TFP relies on professionalism, responsiveness to clients' needs and relevance in the market place to establish and maintain its high reputation. In terms of its ability to process large numbers of small transactions in an efficient manner, the TFP is unique in the Bank's product offering. The nature of the business and, in particular, the requirement for fast transaction turnaround does not always sit easily with the Bank's traditional project finance-type approach and refinements have been made over the years to enhance procedural aspects of the TFP and reduce risks. The latest such adjustments were made following an Internal Audit review in 2009 and their implementation is not reflected in the EvD due to timing differences.

While the Report does give credit to certain positive achievements of the Programme, not least the positive client feedback, it also raises some critical issues and recommends significant changes to the way TFP operates. Management does not share all of EvD's conclusions, nor agree with all of the Recommendations. However, Management does agree with the key Recommendation, that after 10 years of operation, there be a strategic review and fundamental reassessment of the TFP. Management undertakes to conduct this review and address the Report's Recommendations in a comprehensive manner, rather than seeking to respond to them without the strategic context. Management will report to the Board before the end of 2010.

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RECOMMENDATIONS

1. Strategy

Recommendation 1: TFP, in conjunction with FI Management and internal stakeholders, must draft a Strategy Paper revisiting all aspects of future implementation of TFP.

The strategy paper should include a restatement of: a) programme objectives; b) conformity with the Bank's mandate and agreement establishing the Bank; and c) TFP's operations. The new strategy should be updated periodically to take account of changing market conditions and markets gaps and the extent to which this impacts on TFP. It is strongly recommended that the development of the new strategy is accompanied with a move away from the current undifferentiated approach where all transactions and counterparts are largely considered equally in the achievement of objectives regardless of the nature of trade, counterpart or stage of the trade cycle being supported (Section 5).

Management Comments: Management agrees to undertake a comprehensive review of the TFP and to report to the Board on the outcome of this review by January 2011.

Recommendation 2: The TFP product should be redesigned around the revised strategy.

This should include introduction of a structured approach to benchmarking and planning TFP objectives with each issuing bank, including capacity building objectives and role of TC. Redesign of the product should result in a greater focus on identifying and addressing constraints to the development of trade finance in banks participating in TFP.

Management Comments: Management agrees that the TFP products must be consistent with the objectives of the programme. These objectives, and the steps to be taken in achieving them, will be key results of the review.

Recommendation 3: TFP must develop an agreed framework for measuring success that reflects the new strategy.

A new performance measurement approach must break with the past approach of 'more is always better' by including metrics that go beyond input/output measures. Future performance measurement must also distinguish between those objectives which have been already achieved (such as the establishment of networks for banks that are new to trade finance) and those that relate to the reporting period being presented to avoid "recycled" achievements (Section 5.1.2).

Management Comments: Management does not accept EvD's premise of a past approach focussed on "more is always better". The EvD report, possibly because of the nature of the sample transactions chosen, may not have devoted sufficient attention to important success indicators such as average transaction size and number of intra regional transactions. Management considers that the measurement of success must reflect both the objectives of the programme and the circumstances of specific countries and clients, and will seek to enhance this approach to performance measurement as part of the Programme review.

Recommendation 4: A new approach to TI should be developed in consultation with OCE to accompany the restated strategy.

The approach should differentiate clearly transition objectives from operational objectives. The approach to TI must reflect the restated strategy (Section 5.2).

Management Comments: Management will ensure that the team continues to work with OCE to ensure that TI objectives remain relevant, and are enhanced where necessary, following the review.

Recommendation 5: For certain countries where transparency is lacking, TFP must ensure its activities are aligned to EBRD's country strategy.

In consultation with FI management, TFP must review their activities in Azerbaijan especially where TFP activities appear to be inconsistent with EBRD's aim to encourage more transparency in business practices (Section 6.5.2).

Management Comments:

Management fully agrees that TFP activity, like all Bank activity, must be aligned with the Azerbaijan Country Strategy (and all other Country Strategies) in all respects, including, inter alia, the need to "…increase transparency especially with respect to banking relationships between related parties".

The Recommendation expresses particular concern about business practices in Azerbaijan. Follow up discussions with EvD highlighted their concerns about companies structuring their imports, including those facilitated through TFP guarantee transactions, to minimise tax obligations.

We note that many Azeri importers prefer to buy goods at the factory gate in the country of origin and then use Azeri transport companies and forwarding agents for the transport of goods from the country of origin to Azerbaijan and the related customs clearance and logistics.

It is quite common in international trade for importers to use domestic transport companies and forwarding agents, especially when these are able to deliver cheaper and faster transport and customs clearance than the exporter and foreign forwarding agents can provide.

Under the TFP the EBRD provides trade finance facilities only to banks and does not lend directly to importers and exporters in Azerbaijan. TFP client banks have confirmed to the EBRD that their sub-loans are in compliance with Azeri laws and there is no indication that TFP client banks or their sub-borrowers have been involved in illegal or non-transparent activities.

Recommendation 6: TFP should be disaggregated from the FI scorecard at the first opportunity.

Clear, and stand alone, operational performance targets should be established consistent with the restated strategy. Operational targets for TFP should be largely ring fenced from FI's targets to reduce the 'on-off' approach by FI management which has been observed in the past (Section 6.1).

Management Comments: The TFP is one of many product areas in the Financial Institutions Business Group. Operational performance targets for all groups, including TFP, are set annually as part of the FIBG Business Plan.

The TFP is a key component of the Business Plan in terms of over all business volume, geographic distribution and transition impact. The Business Plan is delivered by different teams in FIBG working flexibly together to achieve results. This formula has delivered strong results on a consistent basis over a lengthy period of time and through shifting business environments. The on-off approach referred to by EvD is in fact a reflection of the uncertainties surrounding the Bank's business which can impact on all team and Business Groups, not just TFP and FIBG. Management does not believe that any business of the Bank can be reasonably ring fenced as the EvD Report suggests, without leading to loss of flexibility in achieving overall business objectives.

Recommendation 7: Parallel to ring fencing trade facilitation activities, Management should consider refocusing the approach to managing this business unit to ensure accountability of line management for achieving the objectives set.

The level of the manager of the unit should reflect the strategic importance of the Trade Facilitation Programme in the Bank (2.4 and 6.).

Management Comments: As noted by the EvD Report, TFP is one of a suite of products delivered to EBRD's banking clients for supporting enterprises in Countries of Operation. Rather than ring fencing or disaggregating the TFP from the rest of FIBG, Management strongly advocates the continued integration of TFP.

Accountability of line management and bankers is achieved through setting and review of appropriate objectives. The human and financial resources allocated to TFP should reflect, and Management believe do reflect, the importance of the Programme to EBRD and its clients.

2. Control

Recommendation 8: Clear demarcation lines need to be established between TFP products and other overlapping products of the Bank.

Failure to establish demarcation lines encourages arbitrage between the various products (eg SME credit lines and agri-finance credit lines) by participating banks and tarnishes the reputation of the EBRD (Section 6.5.1).

Management Comments:
Management does not share the view that clients choosing among EBRD products tarnishes the reputation of the Bank, providing eligibility criteria are met. Each product is aimed at serving a particular segment or activity, and at times there may well be overlap. Banks are not, and should not be, precluded from using SME Credit Lines, their Agri-Finance Credit Lines or indeed an Energy Efficiency Facility to support their clients' foreign trade activities if such clients qualify under the relevant policy guidelines. Similarly, SME clients whose transactions qualify under the TFP are permitted to use the TFP to finance their activity. The key feature is that the transaction must meet the eligibility criteria.

Following the Recommendations of the 2009 Internal Audit Report, additional measures have now been put in place to ensure that TFP transactions meet the eligibility requirements for the TFP.

Recommendation 9: A task force should be established to unify the rules, authorities, limits applicable and monitoring processes and there is no single reference document for the multiple levels of delegated authority that exist for TFP (Opscom, Credit, OAU, ESD and TFP itself).

These should be restated to the Board. Limits and authorities (not monitoring processes) should be represented to the Board at each Board paper clearly identifying, for example in edit tracker, any changes resulting from the Board document. If the Board document does not require any change to the authorities, there should be an explicit statement to this effect and the document could be omitted. Guarantees are issued with no external processing involvement (compared to cash advances, which are signed off by OAU). Management should restate their support for this exceptional arrangement and re-affirm the rationale. Clarity must be provided on the scope of TFP authority to engage with public sector entities. Limits, authorities and monitoring processes should be recorded in TFP's Operations Manual, which should be made available on the Banks Intranet (Section 6.6).

Management Comments: Management agrees that the authorities provided by the Board should be restated with more clarity. All relevant stakeholders will be canvassed and the resultant authority matrix will form part of the proposed TFP review document.

Recommendation 10: External limit monitoring should be established.

At present, TFP selfmonitors the Board-agreed limit of (a maximum of 20 cash transactions over USD 20 mn per year and large and) long tenor guarantees not exceeding 10% of the programme limit. Monitoring of framework level limits should be established outside of the TFP team (Section 6.6).

<u>Management Comments:</u> Management agrees that the monitoring of framework level limits should be established outside the TFP team. The mechanisms for implementing this will be explored during the forthcoming review. In the specific case noted in the Recommendation it should be noted that cash transactions in excess of USD 20 million are not permitted. However, the utilisation of TFP facilities for guarantee transactions with tenors of more than 3 years should and will be monitored outside Banking. Tenors for over 3 years are only possible for intra-regional trade and exports from EBRD countries. Maximum transaction size is USD 5 million, with not more than 20 transactions per year and total outstandings not to exceed 10 per cent of the total programme.

Recommendation 11: Enhanced processes and vigilance are required to deal with multiple transactions to the same obligor on similar drawdown and maturity dates which are suspiciously close to delegated authority limits.

In order to avoid "contract splitting" practices, the onus should be on TFP to flag borderline transaction, establish the bone fides of these transactions and record TFP conclusions on the transaction file.

<u>Management Comments</u>: Management has found no evidence of contract splitting in the past and confirms that such practices will not be permitted under the TFP. Vigilance is nonetheless necessary and Management considers that the controls instituted in 2009 following the Internal Audit Report would identify transactions which appear to involve contract splitting.

Recommendation 12: TFP must cooperate with ESD to rectify deficiencies in environmental execution.

TFP transaction files must record the relevant characteristics of transactions to ensure that TFP makes appropriate referrals to ESD. It is vital that TFP ensures participating banks rate all transactions submitted or express, explicitly, the exemption from rating. The nature of the goods needs to be specified and there needs to be sufficient clarity over the provenance of goods or commodities, applicants and intended end-use to enable cross-reference to the environmental policy. Insufficient information alone should be sufficient reason for not processing a transaction. ESD needs to provide additional training to TFP and engage the participating banks to ensure they understand what is required of them. All High Risk transactions should be referred to ESD and tracked by ESD for their outcome, including monitoring of referred high risk transactions to ensure ESD requirements are implemented. This recommendation is supported by ESD. (Section 6.3).

<u>Management Comments</u>:

Client banks are informed about the operational terms and procedures of the TFP. Documentation includes a dedicated section on the TFP Environmental and Social Procedures (ESP) stipulating which goods and services can be supported by the TFP and under which circumstances. Experience shows, however, that the first few transactions with a new issuing bank under the Programme typically need a certain amount of guidance from TFP staff on the ESP.

These ESP have always been an integral part of the TFP, detailing what kind of products and services the Programme is able to support. As mentioned in the EvD report, trade finance transactions require a quick turnaround because of the nature of the business and a fast track review is an essential element of the Programme. TFP's ESP have been developed to support such requirement, while ensuring that the Bank's general environmental and social procedures are accurately reflected in the document. Over the years the TFP's ESP have been regularly updated in order to implement recommendations of past Internal Audits or to reflect any changes in the Bank's environmental and social procedures. The current version of the ESP provide clear wording when a potential transaction qualifies as high risk and when an Environmental and Social Review Summary (ESRS) has to be produced and forwarded to the ESD.

In terms of practical implementation, when EBRD receives an application for a trade transaction, TFP team members check the goods/applicant/end user of the underlying transaction, together with its risk classification. Every application for a guarantee or cash disbursement also includes a confirmation by the issuing bank that the goods of the underlying transaction are not listed on the TFP's Environmental and Social Exclusion List. ESD is only involved in the transactions where an ESRS is forwarded for approval, as in the overwhelming majority of TFP transactions are rated low risk. The current wording of the ESP is clear on how to classify goods of the underlying transactions and where there are doubts on classification, the TFP team routinely rejects the transaction.

It is important to note that due to the nature of TFP business, with the major part of operations characterised as low risk and with the large number of transactions for which EBRD support is requested, it is not considered practical to apply a risk rating for every TFP transaction being processed.

However, in order to address EvD's recommendation, the TFP team will work with OGC to include in the guarantee and disbursement application a clear and relevant clause that requires issuing banks to identify and assess high risk transactions based upon environmentally/socially high risk activities or substances with reference to the ESRS. All high risk transactions will be referred to ESD as before, but in future will also be tracked by ESD to ensure ESD requirements are implemented. In addition and in order to provide all banks with enhanced environmental training, the TFP will together with the ESD design a module on environmental and social training for inclusion in the recently introduced on-line TFP training course.

Recommendation 13: TFP Environmental Procedures should include a clear definition of exemptions for Commodity Trade finance. Annex 4 of the TFP Environmental Procedures should be reviewed.

New content should be introduced providing guidance on the definition, commodities exempted and any issues of provenance related to the exemption from risk rating under the concept of "commodity trade finance". None exists at present. All transactions exempted from risk rating should be explicitly recorded as such and the reasons stated. This recommendation is supported by ESD. (Section 6.3).

<u>Management Comments</u>:
Although the word “commodity” is a well-known term in trade finance, the TFP will include a definition in the ESP of what is regarded as “commodity trade finance” in order clearly to specify such term. All environmentally/socially high risk commodity transactions will be flagged in the guarantee or disbursement request and will follow the standard procedures outlined above for high risk transactions. Furthermore, ESD will identify a number of additional commodities with very high environmental and social risk which will be included into the TFP’s Environmental and Social Exclusion List of activities not eligible for TFP support. ESD has also cross checked Annex 2 “Environmentally and Socially Sensitive Sectors” with Annex 4 “Environmental and Social Risk Categorisation List – 2008” of the ESP in order to assure that all environmentally and socially sensitive sectors as per Annex 2 are covered and flagged by the latest version of such categorisation list.

3. Technical Cooperation

Recommendation 14: TFP should develop a strategy and implementation plan for its TC activities.

The strategy should validate and scope out market needs, rank priorities and establish a timeframe for execution of TC. A regularly updated TC implementation plan should describe TC objectives, target participants and counterparts, performance measurement, delivery mechanism and financing requirements including a move to cost recovery. It is recommended that consideration be given to repeat TCs where warranted. In developing the TC strategy TFP should work in conjunction with the Official Co-Financing Unit and consult with donors over their requirements and conditionality for supporting TC initiatives. It would be highly desirable for TC planning to be set in the context of a logical framework, or similar programme planning tool. A monitoring and reporting approach should be developed for all future TC activities at the level of the TFP framework (Section 3.6). Future TC planning should give consideration to including Environmental and Social due diligence training and incorporation of an Environmental and Social Due Diligence Module in the recent on-line training course launched by TFP (Section 6.3.1);

<u>Management Comments</u>: Management agrees that the objectives and implementation of TC activities should reflect the approach that is ultimately approved for the TFP after the Programme review. The TC programme has been an integral part of the TFP, but further efforts will be made to enhance TFP planning.

4. Bank Handling

Recommendation 15: The current TFP approach to AML and similar issues requires a comprehensive overhaul.

The approach should be developed in conjunction with Office of the Chief Compliance Officer (OCCO) and other internal stakeholders as necessary. Procedures should be incorporated into the TFP Operations Manual and a tailored programme of training for TFP staff and participating banks developed and implemented to ensure process and procedure follow through into implementation (Section 6.2).

<u>Management Comments</u>:

Financial Institutions (FI) uses the same AML procedures for all projects, including the TFP.

Following recommendations of Internal Audit in 2009, the Bank has introduced new procedures to mitigate any increased reputational risks resulting from the financing of sub-borrowers located outside countries of operations. These measures include follow-up of the documentary trail in respect of any such transactions to ensure that they did in fact result in an import into, or export from, the relevant country of operation, and to assess whether there are any indicators of tax evasion, money laundering or terrorist financing schemes, or inconsistent terms of trade.

Such steps taken meet, and in most cases, exceed the control standards embedded in "**The Wolfsberg Trade Finance Principles".** This is the AML response to Trade Finance adopted by the leading international bank forum, the Wolfsburg Group.

These steps have been agreed with Internal Audit and Management believes that these new procedures are an appropriate response to the concerns that have been raised. Management does not consider that an overhaul of the TFP's approach to AML is warranted, but will liaise with OCCO and reflect any agreed adjustments in the review document.

Recommendation 16: TFP in conjunction with OGC and Credit should review and clarify its position on, and approach to, documentation risks, as differentiated from the credit risk of the issuing bank.

TFP must present a clear approach as to how this form of operational risk is to be controlled/minimised by the Team (Section 3.3.4).

<u>Management Comments</u>:

It is important to be clear on the role of EBRD in TFP transactions. Confirming banks, which are approved for the Programme on the basis of their expertise in documentary trade finance transactions, explicitly take responsibility for the documentation.

EBRD is not involved in reviewing documentation flows of the underlying trade finance transaction after issuing a guarantee to the confirming bank. Management accepts that documentation risk is an inherent risk of trade finance activities but considers that this risk is appropriately mitigated under the standard TFP documentation. If a Confirming bank makes a claim under an EBRD guarantee, it has to represent in its claim to EBRD that documents presented in connection with the underlying transactions are either (i) compliant with the terms of the underlying eligible instrument or (ii) that the issuing bank has accepted the underlying documentation. Such a representation from a confirming bank makes it unlikely that claims are made to EBRD in case of a dispute on documentation between the issuing bank and the confirming bank. EBRD can also take comfort from the fact that a confirming bank bears significant reputational risk should it make false representations to EBRD, including the possible exclusion from the Programme in future.

Ultimately, in case of any payment to the confirming bank, the EBRD has the right to claim this amount back from the issuing bank.

Recommendation 17: Banking must introduce a process of monitoring for TFP in line with other frameworks.

It is recognised that the standard monitoring formats may not be appropriate for TFP. Under other frameworks a tailored approach has been developed to monitoring that meets the requirements of the Bank's control departments.

Management Comments:

All TFP facilities under the framework are subject to standard monitoring procedures.

The monitoring of the framework includes a yearly Project Monitoring Report (PMR) to Credit with extensive information on quality and regional distribution of the programme portfolio and the performance of the Programme. This includes statistics such as total outstandings, business volume, number of guarantee and cash transactions, high risk areas and other business activities. In addition, the TFP provides half-yearly reports to the Board.

EBRD client banks are typically monitored on a client rather than a product basis, with a review of both the financial standing of the bank and the bank's exposure to EBRD products, as part of the regular monitoring processes involving Banking and Credit.

Recommendation 18: The current TFP approach to collecting and sharing market price information should be overhauled.

A new process and procedure is required for collecting and disseminating market price data and the availability of risk cover (volume and tenor) for countries and banks covered by TFP. Market price data and risk availability should be sought from commercial banks, private credit insurers and ECAs. TFP should not be the sole originator of the data. Market price and coverage data should be used to both inform TFP pricing to be agreed with Credit Department and ensure that TFP is maintaining additionality (Section 6.7).

Management Comments: In 2009 new procedures were introduced which require quarterly revision and re-approval of the pricing of all TFP facilities by the TFP Team and Credit. Market price data and risk availability are regularly collected by the TFP Team and Credit from commercial banks, private credit insurers and ECAs. Management does not consider that this approach should be overhauled, but Banking will conduct further discussions with Credit in preparing the review document.

Recommendation 19: FI should consider whether it is appropriate to offer financing specifically for working capital purposes (which is how TFP cash advances have been used predominantly by participating banks) and make explicit product proposals to the Board as necessary.

TFP's cash advances, except those transactionally secured by the participating bank, are being used by participating banks to provide working capital facilities. FI should explore the extent to which working capital finance is a legitimate area for product development and one where EBRD can offer a core competence (Section 3.3.3.1).

Management Comments:

All products that are being offered under the TFP and may be offered in the near future will be considered in the upcoming review of the TFP and explicitly detailed and explained to Board.

Management considers that cash advances for trade purposes, with appropriate checks and monitoring, represent a completely bona fide trade finance product for the Bank. There is no evidence that TFP client banks have ever used TFP cash advances for *general* working capital requirements of their clients, as for example payment of rent or salaries.

In order to ensure that TFP facilities are used only for financing of specific trade contracts, the Bank introduced new procedures in 2009, under which TFP client banks are required to provide the EBRD not only with a sub-loan report, but also with

- copies of the underlying trade contracts
- copies of the sub-loan agreements
- copies of invoices, transport documents and customs declarations (held on file by TFP client banks and checked by the EBRD through annual spot checks).

The EBRD has now the strictest control over use of funds for trade finance of any financial institution worldwide, including all other IFIs.

Recommendation 20: New implementation procedures must be prepared and implemented for post LC financing to ensure use of proceeds for trade purposes.

Post LC financing has been found to present similar risks concerning linkage with trade as found in cash advances (Section 3.3.3.2).

Management Comments: Following recommendations of Internal Audit, the Bank now requests copies of the sub-loan agreements and checks utilisation of funds on the occasion of annual spot checks of documentation held on file by client banks. Post LC financing will be among the products that will be considered as part of the overall review to ensure an appropriate balance between ensuring correct use of proceeds and additional administrative burden on clients.