DOCUMENT OF THE EUROPEAN BANK
FOR RECONSTRUCTION AND DEVELOPMENT

FINANCIAL SECTOR STRATEGY 2016 – 2020

As approved by the Board of Directors on 13 January 2016

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[1] The analytics used in this annex was prepared by the Office of the Chief Economist in the context of the Transition Report 2015

1. ABBREVIATIONS

ABI	Annual Business Investment
CEE	Central and Eastern Europe
CIS	Commonwealth of Independent States
COO	Countries of Operations
ECB	European Central Bank
EIB	European Investment Bank
ETC	Early Transition Countries
EvD	Evaluation Department
EU	European Union
FDI	Foreign Direct Investment
FIBG	Financial Institutions Business Group
GDP	Gross Domestic Product
GET	Green Economy Transition
ICGI	Investment Climate and Governance Initiative
IFI	International Financial Institution
IMF	International Monetary Fund
LC2	Local Currency and Capital Markets (initiative)
LTT	Legal Transition Team
MSME	Micro Small and Medium Enterprise
NPL	Non-Performing Loan
PFI	Partner Financial Institution
PMF	Performance Monitoring Framework
SBI	Small Business Initiative
SCF	Strategic and Capital Framework 2016-2020
SEE	South East Europe
SEFF	Sustainable Energy Financing Facility
SEI	Sustainable Energy Initiative
SEMED	Southern and Eastern Mediterranean
SGI	Strategic Gender Initiative
SO	Strategic Objective
SRI	Sustainable Resource Initiative
TA	Technical Assistance
TFP	Trade Facilitation Programme
TLTRO	Targeted Longer-Term Refinancing Operations
VP3	Vice-Presidency Policy and Partnerships

2. FOREWORD

The Strategy assesses the implementation of the previous strategy, describes the challenges faced by the financial sector within the current operating environment and sets out an operational approach focused on supporting the recovery of the financial system as an effective driver of economic growth and strengthening its resilience against future economic downturns.

The Strategy is consistent with the EBRD Strategic and Capital Framework 2016-2020 and it recommends a comprehensive package of activities in support of three proposed strategic objectives:

1) Development of a sound banking sector through improvement of business standards, restructuring and consolidation, and increased competition.

2) Strengthening the financial sector by achieving better diversification (including the development of the non-banking sector) and integration into global financial markets.

3) Fostering deeper and broader financial intermediation in countries of operation through innovative financial products to reach under-served market segments and strengthen competition and market effectiveness in the financial sector.

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3. EXECUTIVE SUMMARY

Since the adoption of the first Financial Sector Policy in 1999, the financial sector in EBRD Countries of Operations (COO) has undergone dramatic changes. In the period up to 2008 the sector saw massive growth across most COO, with foreign-owned banks investing heavily in the region. The significant inflow of foreign investment made an important contribution to the economic transition but at the same time led to excesses that contributed to the financial crisis of 2008.

The 2010 Financial Sector Strategy, adopted at the end of 2010, was primarily focused on addressing the consequences of the crisis and on renewing economic growth. Activities under the Strategy were designed to contribute to stabilisation of financial sectors in COO. The economic downturn, however, has proven to be deeper than anticipated and convergence of the emerging and developed markets has slowed down significantly. Banks throughout the world have also come under pressure, but the European banks, many of which invested in the EBRD region pre-crisis, have been hardest hit of all. The scaling back of funding by foreign banks in many COO has coincided with delay or postponement of essential economic reforms, which means that the financial and economic backdrop is much less attractive than in previous years. In the context of limited growth in financial sector assets in many COO, there is often lower demand for the Bank's traditional lending products, and this will require creative and flexible approaches over the coming years in order for transition objectives to be achieved.

The new Financial Sector Strategy will be focused on supporting the recovery of the financial system as an effective driver of economic growth and strengthening its resilience against future economic downturns. The new Strategy will be based on the following strategic themes and strategic objectives:

1) Supporting resilient and efficient banks

This strategic theme will correspond to a strategic objective of: *development of a sound banking sector through improvement of business standards, restructuring and consolidation, and increased competition*.

The operational focus here will be on projects that contribute to: a) market competition; b) improving corporate governance and management standards; and c) addressing the causes of stagnating or dysfunctional banking sectors.

The Bank envisages two main avenues of engagement in relation to this strategic objective. One avenue will be through the banks that weathered well the difficult market environment, and have demonstrated the strength of their corporate governance and viability of their business models. By supporting such banks EBRD will seek to: i) strengthen market competition in the context of a particular financial sector; and ii) signal to the market the type of financial institutions and market behaviour EBRD is ready to endorse through its financial support. The other avenue will be through the banks which retain a systemic importance despite failing or coming close to a failure in the crisis and where they still have an important role to play in the economy. EBRD will aim to restore such banks' competitiveness by improving their corporate governance and by facilitating operational and balance sheet restructuring through business turnaround, business consolidation or privatisation.

The Bank will deploy the entire range of its financial instruments to pursue this strategic objective. However, the most appropriate financial instruments are likely to be direct equity investment in banks and capital support instruments (including regulatory capital transactions, NPL and distressed asset acquisition, and other risk-transfer financial solutions). Policy dialogue will accompany the investments and provide support whenever necessary for reform implementation.

2) Improving financial sector effectiveness and integration

This strategic theme will correspond to a strategic objective of: *strengthening the financial sector by achieving better diversification and integration into global financial markets.*

Here the operational emphasis will be on: a) developing the non-bank financial sector as a viable alternative to bank financing; b) through policy dialogue improving the institutional, legal and regulatory environment and financial market infrastructure to enable the development of local currency and capital market activity; and c) development of new financial solutions / products in the market.

In the context of this strategic objective EBRD will focus on supporting established non-bank financial institutions that either play a central role in the financial sector infrastructure (e.g. exchanges, clearing platforms, custodial service providers, deposit insurance agencies, etc.) or contribute to the financial sector diversity and effective operation of capital markets (insurance companies, asset management companies, pension funds, leasing companies, etc.) or by participating to the issuance of capital markets instrument such as bonds. By enhancing and expanding the role of such non-bank financial institutions through its financing projects the Bank will seek to accelerate the evolution of the financial sector in a given country and its better integration into the global financial system. EBRD will use a mix of debt and equity instruments to pursue this objective. In the context of this strategic objective, policy dialogue and technical assistance will play a critical role in helping EBRD to address the legislative or regulatory obstacles that impede the development of non-bank financial institutions in COO.

3) Enhancing financial intermediation

This strategic theme will correspond to a strategic objective of: *fostering deeper and broader financial intermediation in COO through innovative financial products to reach under-served market segments and strengthen competition and market effectiveness in the financial sector.*

The operational focus will be on projects that contribute to: a) economic inclusion; b) access to finance of underserved customer segments, particularly MSMEs; c) development of financially sustainable forms of investment in energy efficient production and energy use; and d) transfer of skills, investments in technology or innovative products or processes.

The Bank will work towards achieving this objective through a combination of established operational competences and new types of activities. The former will include operations under the core EBRD strategic initiatives – SBI, SGI and GET – where EBRD will continue supporting local MSMEs through its debt and equity operations for banks and non-bank financial institutions and will continue promoting financially sustainable energy efficiency projects.

The Green Economy Transition (GET)

In September 2015 the EBRD Board approved the Green Economy Transition Approach (BDS15-196) which will enable the Bank to scale up its climate financing and resource efficiency activity and broaden the scope to include natural capital resilience and restoration.

The Green Economy is defined as "*a market economy in which public and private investments reduce the impact of economic activity on the environment and where market failures are addressed through improved policies and regulations to systematically account for the inherent value of services provided by nature, in order to manage risk and catalyse innovation.*"

The shift to an environmentally sustainable economy is centred on the transformation of markets, behaviours, products and processes, technological deployment and new skills. The GET approach is based on the transition and client-driven business model of the EBRD and in line with its operating principles of transition impact, sound banking and additionality.

The Bank will also seek to expand its operations in customer segments that are economically active but either excluded from or insufficiently covered by formal financial services. In the context of SBI, for example, that would be SMEs engaged in research and development or who demonstrate innovation, agricultural SMEs and women entrepreneurs.

In relation to the new types of activities, the focus will be on expanding operations with non-bank financial institutions. However, unlike in the context of the previous strategic objective, here the focus will be on the "market challengers", the new types of non-bank financial institutions that through technological innovations or disruptive business models are able to offer unique or enhanced value proposition to customers and by doing so challenge the incumbent market players. Examples of such market challengers include electronic peer-to-peer lending platforms, virtual banks and financial service providers, and non-deposit taking lenders (often called "shadow banks").

Activities under the new Financial Sector Strategy will be aligned with the Bank's Strategic and Capital Framework (SCF)[2], EBRD strategic initiatives and with EBRD Country Strategies:

- activities under the strategic objective of developing sound banking systems will be in support of the Bank's SCF medium term directions and in collaboration with other partners and IFIs, under the Vienna Initiative;
- the objective of strengthening the financial sector effectiveness through diversification and integration into global financial markets will be pursued in conjunction with EBRD's ICGI and LC2 strategic initiatives;

[2] BDS15-013(Final)

- while the activities aimed at achieving the strategic objective of fostering deeper and broader financial intermediation will be aligned with a wide array of EBRD's strategic initiatives, including SGI, SBI, GET, LC2 and ICGI;
- in accordance with the new enhanced and structured approach to policy reform dialogue, policy dialogue activities under this Strategy will be stepped up and prioritised based on in-depth country analysis and operational priorities of the Bank in the financial sector with a view to exploiting the EBRD's unique capability to mobilise private sector engagement.

The planned alignment of the Bank activities with the strategic initiatives and Country Strategies is elaborated in Section 7.

The Bank will continue actively cooperating with IFIs, in particular in the context of "blended finance" transactions (where the Bank's commercially-priced financing is blended with non-TC grants) and policy dialogue and will seek complementarity of such activities when they are delivered by IFIs in a single market or to a particular PFI. Where operationally feasible, the Bank will also continue to seek co-financing opportunities of debt and equity projects with other IFIs.

4. INTRODUCTION

This document is organised in the following structure:

- Section 5 discusses the Bank's activities, achievements and assesses its overall effectiveness against the objectives of the Financial Sector Strategy 2010
- Section 6 lays out the current economic environment in COO and key strategic challenges
- Section 7 proposes the strategic objectives and tactical objectives and outlines the direction of the Bank's activities under the new Financial Sector Strategy.

5. ASSESSMENT OF THE 2010 FINANCIAL SECTOR STRATEGY IMPLEMENTATION

The Financial Sector Strategy adopted in October 2010 was focused on crisis response and on renewing lending to the real economy in the transition region. The prolonged nature of the financial crisis triggered economic recession in many COO and became a serious impediment to implementation of the Strategy. Notwithstanding the negative environment, during the last five years the activities of EBRD contributed to buttressing (in many countries) or expanding (in fewer countries, where the environment was more conducive to growth) lending to the real economy. Looking back over the period, at the heart of the Strategy has been the maintenance of confidence in the financial sector in COO.

This section assesses the implementation of the Financial Sector Strategy 2010 against its five strategic objectives, and presents a summary of the analysis undertaken by the Evaluation Department (EvD) of financial sector projects against the Financial Sector Strategy 2010.

1. Complete the crisis response activities and stimulate lending to the real economy

Crisis Response

The crisis response activities of the Bank concentrated on supporting the systemically important financial institutions in COO. Under the first Joint IFI Action Plan EBRD provided crisis response financing to local subsidiaries of international banking groups, helping alleviate systemic risks that would have arisen from a withdrawal of the banking groups from the region. While the Bank's financing was undoubtedly valuable at a time of severe liquidity constraints, the signalling of continued support for the financial sector in an extremely challenging environment was ultimately equally important.

Although the acute stage of the crisis has passed, dealing with its aftermath still represents a key challenge and, at least in a medium term, will remain a key part of the Bank's work as it seeks to develop a robust banking system across COO.

MSME Lending

The financial crisis had a disproportionately strong impact on MSMEs across the region, with small businesses finding themselves unable to borrow at economically acceptable terms. Consequently, promotion of MSME financing was at the centre of the Bank's efforts to stimulate lending to the real economy in COO. The full spectrum of instruments was utilised in support of that objective – from trade finance and senior lending to equity investing. During the last five years EBRD extended its outreach to local MSMEs by providing MSME financing for the first time to 76 partner financial institutions (PFIs). Sector coverage was broadened through a range of specialised lending programmes such as the Georgian Agricultural Finance Facility and Turkey Agribusiness SME Finance Facility aimed at supporting agricultural MSMEs; and through innovative structured finance transactions, such as Diversified Payment Rights (DPR) and Asset Guaranteed Bonds, where the proceeds supported new MSME lending. In support of the Bank's Gender Initiative, EBRD structured Women in Business lending frameworks and delivered dedicated financing to women entrepreneurs in the Western Balkans, Egypt, Croatia and Turkey. Overall, in the last five years over EUR 4.4 bln was invested to support MSME lending in more than 330 transactions across 28 COO. At the end of 2014 the Bank had 206 PFIs active in MSME lending. Their combined MSME loan portfolio stood at EUR 11 bln, consisting of almost 2 million loans.

Trade Facilitation Programme (TFP)

The TFP continued to be an important source of trade finance in many COO. The Programme continues to support economic activity across the region, but it can be particularly powerful in countries where it is – at least in a short term – difficult for the Bank to deploy its full range of products. For example, the Programme has remained active and highly additional in Ukraine since the beginning of the political and economic turmoil; and it has helped the Bank to start establishing banking relationships in SEMED, where traditional senior debt is taking longer to gain traction.

TFP has handled 7,764 transactions worth over EUR 5 bln in the Strategy period. Half of these transactions were in the ETC region. The TFP has undertaken business with 111 issuing banks covering 26 COO and 44 new banks from across the region have joined the Programme in that time.

The Bank initially anticipated that the increased focus on supporting trade finance would be only temporary. With the subsequent introduction of new bank capital regulations, the growing risk aversion of commercial banks and the increased cost of compliance arising from cooperation with banks in smaller, less developed markets, the TFP is now more relevant than ever.

SEFF

As a core component of SEI[3], the Bank's Sustainable Energy Financing Facility (SEFF) was expanded to promote energy efficiency among local businesses across the region. The SEFF

[3] Presently a part of the GET Initiative

outreach was extended to 95 PFIs (63 added since end-2010) operating in 22 countries (15 at end-2010).

By using the well-established SEFF platform combining financing with policy dialogue and technical assistance, EBRD has delivered energy efficiency improvements in an effective way which has become a model for other IFIs around the globe.

Since the inception of the SEI in 2004, the Bank has disbursed SEFF loans worth over EUR 2.44 bln to PFIs which have on-lent EUR 1.97 bln to sub-borrowers, supporting over 94,600 sustainable energy projects.

Equity Investing

The depressed post-crisis environment significantly reduced business investment activity in the transition region. In combination with the constrained ability of banks to lend, growth investing became generally unattractive and investment opportunities limited. During the last five years, EBRD sought and supported growth investment opportunities in markets where such investments were still possible, with examples including: the IPO investment in Alior Bank in Poland; the early-stage investment in Meritum Bank in Poland; an investment in a fast growing asset manager LBT Varlık Yönetim A.Ş. in Turkey; an investment in the Bucharest Stock Exchange in Romania; an investment in the Moscow Stock Exchange; and an investment in Credit Bank of Moscow in Russia.

An increasing number of investment opportunities were related to restructuring and turnaround situations. EBRD reviewed a number of such proposals in Romania, Hungary, Slovenia and Bulgaria, but was often not able to progress due to structural or valuation issues or concerns over economic viability of the investment case. However, three investments made since mid-2014 indicate that there is investor appetite for appropriately structured deals: recapitalisation investment in the Bank of Cyprus; acquisition of the SEE subsidiaries of Hypo Alpe Adria with Advent International; and acquisition of the second largest Slovenian bank, NKBM, with Apollo Global Management. The Bank will have the benefit of this recent experience as it looks for appropriate conditions on which to engage in the Greek financial sector. Across the region further opportunities are likely to emerge as M&A activity starts to gain momentum and banks revisit their priority markets for deployment of capital.

Over the last five years the Bank made 21 new equity investments and 38 capital increases, fully exited 47 and partially exited a further 9 investments. On the back of the reduced flow of new investment projects and intensified focus on exits over the period, the Bank's equity portfolio in the financial sector reduced from 86 to 60 active investments.

Technical Assistance and Policy Dialogue

Technical assistance and non-TC grants have played an increasingly important role during the last five years. Since end-2010 the Bank has completed 423 technical assistance projects related to financial institutions for a total amount of EUR 110.6 mln, supporting on average 35% of the FIBG's annual business volume (excluding TFP).

Out of 423 TC projects 76% were of advisory nature only, while 24% combined a mixture of advisory services and grants. The latter played a particularly important role in the Group's activities that aimed to advance the Bank's strategic initiatives. As mentioned above, the Bank developed and promoted new products under the GET, SBI and SGI such as Women in Business and Private Sector Support financing facilities. All of these products included a grant financing component and benefited from donors' generous support, particularly of the European Union which contributed around 54% of the overall donor funding for the financial sector since end 2010.

The Bank's financing activities were also supported by intensive policy dialogue with a focus on strengthening financial sector infrastructure and its resilience in the face of potential further shocks and crises. The main areas of the policy dialogue were:

- strengthening/reforming the legislative framework, especially around effective functioning of financial sectors and local currency / local capital markets development;
- strengthening the safety net via enhanced deposit insurance organisation and legislation;
- diversifying / expanding the financial sector through financial inclusion projects.

During the last five years the Bank completed 41 standalone policy dialogue assignments for a total amount of EUR 4 mln, although the policy dialogue element was also present in a number of other TC assignments such as SEFFs.

The advancement of EBRD's technical assistance and policy dialogue activities would not have been possible without the active development of donor relationships and IFI cooperation. The step-change in the level and intensity of IFI cooperation in the aftermath of the financial crisis has underlined how IFIs working together can achieve a stronger impact than working alone. Significant room for further improvement exists, especially in relation to better utilising and sharing unique institutional competences and finding a way to complement each other on the operational level. Some of the challenges ahead for the financial sector in the region over the next Strategy period, starting with Ukraine, but also including comprehensive action to address NPLs, can only be successfully met if IFI efforts are consistently joined.

2. Promote broader use of local currency and help develop local capital markets

The post-crisis period presented an opportunity to reduce undue reliance on foreign savings, develop local currency markets and reduce lending in foreign exchange to un-hedged borrowers in the region. The Bank worked actively in the financial sector to promote the LC2 initiative through the following key activities:

- *Investment in Capital Market Instruments*

  EBRD supported the reintroduction of simplified and transparent forms of structured finance in Poland, Russia and Turkey with a dual objective of helping financial institutions diversify their funding and developing local capital markets. Over the period the Bank participated in 22 bond issues in Kyrgyz Republic, Morocco, Poland, Romania and Turkey, where 15 of these bond issuances were made in local currency.

- *Local Currency Lending*

  During the last five years EBRD continued promoting local currency lending in the financial sector through a number of instruments. Lending in local currency comprised 58 credit lines in Armenian Dram, Georgian Lei, Kazakh Tenge, Polish Zloty, Romanian Lei, Russian Rouble and Turkish Lira. As an investor in the Currency Exchange Fund TCX, the Bank signed 96 synthetic local currency loans in the financial sector. The Bank continued to respond to on-balance sheet currency mismatches by extending cross currency swaps with new projects signed in Poland, Hungary, Romania and Serbia.

- *Investment in Institutional Investor Base and Capital Market Infrastructure*

  EBRD continued actively investing in non-bank financial institutions, pursing the objective of strengthening financial infrastructure in the EBRD markets. The Bank's investee companies included pension funds, factoring companies, insurance companies, asset management companies, collection agencies, NPL companies and the Bank's first investment in a stock exchange. The Bank also provided financing support to deposit insurance agencies for the first time, with five transactions in the Balkans.

In addition to investments, the Bank continued to work on improving the legal and operating environment via its Legal Transition Programme to achieve more efficient financial infrastructure in COO.

3. Assist with better governance, more sustainable business models and improved risk management of banks and non-bank institutions

This objective has primarily been pursued through concrete financing projects, with conditionalities which aim to have a direct impact on the governance and conduct of business of PFIs. The approach was calibrated to the level of development of a financial institution, local economic environment and the Bank's financing instrument. In less developed markets the PFIs are typically required to adhere to enhanced financial performance criteria that often go beyond the local prudential norms. In countries where the banking sector was historically passing on foreign currency risk to unhedged borrowers, greater transparency of terms and disclosure of the foreign currency risk has been embedded in financing agreements. In local economies which display high local currency devaluation or liquidity risks, PFIs are often required to run tighter open currency / maturity positions through financial covenants.

Equity investment projects typically give the Bank greater leverage than debt financing and it has used this leverage to pursue improvements in corporate governance and conduct of business in its investee banks and companies. EBRD Nominee Directors have played a particularly important role in cultivating good corporate governance in EBRD investee-companies. In many instances Nominee Directors brought particular knowledge and skills to improve specific areas of the investee-company's management. Closer engagement with Nominee Directors has been further emphasised in the strategy period through more thorough pre-assignment briefings, setting clear objectives, conducting regular meetings and receiving regular reports during the assignment (while paying close attention to potential conflicts of interest associated with privileged and price-sensitive information).

4. Support consolidation, privatisation and re-privatisation/government exits from the banking sector

Notwithstanding the presence of some fundamental economic incentives to consolidate – such as generally reduced margins and increased fixed costs – the consolidation activity in the financial sectors of COO remained subdued during the last five years. The financial institutions' focus on resolving internal problems, lack of growth opportunities in the markets, absence of strong pressure to divest or restructure, and over-valued (or under-provisioned) assets were among the main reasons for the lack of consolidation activity. One of the rare examples of a successful consolidation transaction was the Bank's support of a merger between Kredyt Bank and BZWBK in Poland.

Further market consolidation may be triggered by regulatory action. The 2014 Asset Quality Review by the European Central Bank has been a catalyst for some banks to re-evaluate their strategies for the region to achieve the most effective deployment of capital. As a result some banking groups may choose to divest from certain regions and /or to acquire presence in other regions. There could be a role for the Bank to support either type of investment opportunity.

5. Support new regulatory frameworks in close coordination with IFIs, including in the area of cross-border regulation

The financial crisis called for stronger collaboration among IFIs to provide a coordinated and focused approach to support the health of the financial sector across the region. A series of initiatives over the period demonstrate the enhanced IFI working relationships:

- The Vienna 2.0 Initiative was launched in January 2012 to address continuing gaps in regulatory coordination. The primary objectives were to reduce the risk of disorderly de-leveraging and to improve the home-host country collaboration in emerging Europe. The key participants were the regulatory authorities, IFIs (including the IMF, the EU, the EIB, the World Bank and the EBRD) and commercial banks. The work aims for practical results by monitoring of, and reporting on, the deleveraging process and by setting up structures where private and public sector decision makers meet to exchange experience and discuss appropriate actions. It is a flexible forum which is able to respond quickly to key challenges facing the region. Work on NPL resolution is expected to dominate the upcoming period.
- The European Union and other donors played a key role in supporting the Bank's and other IFIs' activities, particularly through the Neighbourhood Investment Facility, the Investment Facility for Central Asia and the Western Balkans Investment Facility.
- The Joint IFI Action Plan for Growth in Central and South Eastern Europe (JIAP) was developed within the context of the Vienna Initiative. It involved the EIB Group, the World Bank Group and EBRD and aimed to support economic recovery and growth in Central and South Eastern Europe. Under the Initiative, the three institutions pledged to provide EUR 30 billion in the two years to the end of 2014. The initial pledge was exceeded with a total financing of EUR 42.7 billion provided in the region to support more than 770 individual projects.

- A more recent initiative, the Ukraine Financial Forum, is a platform for constructive dialogue among the key stakeholders in the Ukrainian banking system, including the banking regulator, commercial banks and IFIs. The Forum's objective is to find concrete solutions to the specific and deep problems of the Ukrainian banking system.
- Another recent initiative is the Kazakhstan Partnership Framework Arrangement set up in cooperation with the Government of Kazakhstan and IFIs (World Bank, Asian Development Bank and Islamic Development Bank) to develop commercially viable debt and equity financing in the country. In the context of the Partnership Framework Agreement the Bank worked on two projects in the financial sector – creation of an effective NPL resolution mechanism through the NPL Advisory Platform and continuing to support the earlier conceived project to develop a regional financial centre in Almaty.

In addition EBRD has continued to work on stand-alone projects promoting regulatory reform in specific COO. A recent example of such activity was the work undertaken with the Moroccan Ministry of Finance in revising the collateral regime, which takes place in close collaboration with the World Bank Group and the Arab Monetary Fund.

EvD Analysis of project evaluations against the objectives of the Financial Sector Strategy 2010

The Bank's Evaluation Department (EvD) has contributed to this document with the analysis of the results of project evaluations against the objectives of an informal short review of the Financial Sector Strategy 2010 and concluded that the Bank's Financial Sector Strategy 2010 was relevant in relation to the transition challenges at the time and successful in implementation according to currently available project evaluations (see Annex 1 for more information). The broad recommendations made by the EvD on the back of this analysis will be taken into consideration in planning and executing the new business under the Financial Sector Strategy 2016-2020. The following represents Management's summary of the most common themes present in the reviewed EvD recommendations:

- where commercially and operationally feasible the Bank should prioritise financing in local currency
- the Bank should support financial sector evolution by more actively supporting the non-bank PFIs
- effective corporate governance and strategic management of PFIs is a key factor for successful equity investments
- appropriately structured technical assistance and/or policy dialogue and financing "packages" are likely to be achieving stronger transition impact than each of the components standalone
- the Bank should ensure that PFIs that receive SBI financing are fully committed to developing the MSME lending
- the Bank should continue coordinating with IFIs, seeking complementarity of services in the same markets or with the same PFIs.

6. OPERATING ENVIRONMENT – CONTEXT AND KEY CHALLENGES

The development of the financial sector in COO continues to face significant headwinds. In fact the operating environment in COO remains as challenging as it was five years ago, even though the nature of the challenges has changed. There are three prominent macro forces that fundamentally shape the operating environment in the financial sector:

- Difficult macroeconomic environment

  In most COO GDP continues to exhibit only weak growth or even contract, often in conjunction with the negative dynamics of other economic indicators important for the regional economy such as FDI, Private Credit and Unemployment. Using the IMF and the Economist Intelligence Unit's economic statistics the Bank has mapped for all COO the three-year trend (2012-2014) of these indicators (*see Annex 2*) and found that out of 36 COO:

  - 22 showed contracting GDP
  - 26 displayed a negative trend along at least two of the four macroeconomic indicators;
  - Only 4 countries (Jordan, Morocco, Poland and FYROM) did not show any negative trends; and
  - Only 2 countries (Poland and FYROM) had all four indicators showing consistently positive dynamics.

  The primary effect of such negative macroeconomic environment is that it creates negative economic expectations and reduces the demand for long-term financing from local corporates and small businesses given the lack of or uncertain growth opportunities. This observation is consistent with the first-hand operational experience of the Bank in the region, with many PFIs indicating reducing demand for financing in the real sector.

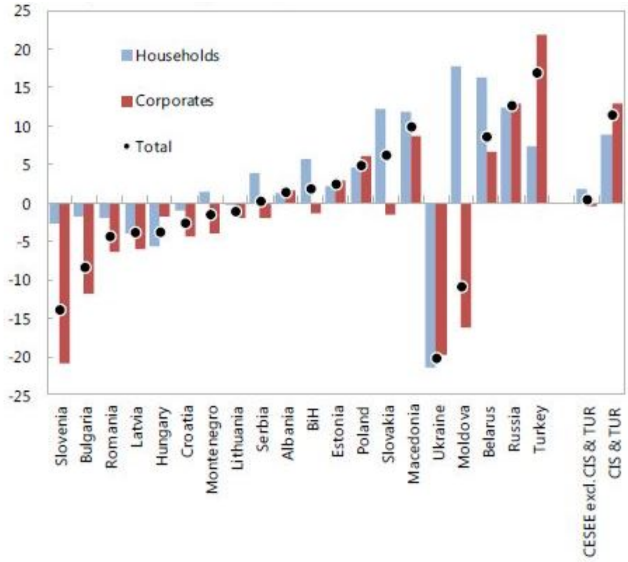
- Tightening of financial sector regulation

  The introduction of the Basel III, CRD IV, Solvency II and other financial sector regulations over time will likely achieve their intended objective of making the financial sector safer and more predictable. So far, however, these regulations have had a negative impact on *the supply* of long-term lending to the real economy by reducing the PFIs' risk appetite and increasing their cost of compliance.

  The reduction of risk appetite is particularly harmful for the segments of the real economy or financial products that are generally regarded as "high risk" – such as MSMEs, start-ups, capex financing and project finance. The same pressures cause banks to focus increasingly on the most creditworthy corporate entities. As a result, this segment tends to be overcrowded, which pushes banks' earnings down, weakens their capital formation and consequently affects their ability to take more risk.

  The increased cost of compliance is prompting financial institutions to exit unprofitable markets, products or customer segments. For example, there is a growing trend of larger European or international banks, driven by the increased cost of compliance and capital charges, to reduce or discontinue their trade finance activities in “non-core” markets or with small client banks.

The combination of these two macro forces – the negative macroeconomic dynamics and tightening of the financial sector regulation – has had a negative impact on *both supply of and demand for* long-term financing in COO, significantly reducing the provision of private credit in the region. The following two charts[4] illustrate this: the chart to the left shows the dynamics of private credit relative to GDP for Central and South-East Europe (red line) and for CIS and Turkey (blue line) from 2009 to 2014. The chart to the right shows the expansion / contraction of private credit by country in 2014 relative to 2013[5].



In most COO this trend has led to excessive liquidity in the banking sector, has driven down profitability and reduced banks’ long-term financing needs. In some markets (notably SEE and SEMED) it has become increasingly difficult for EBRD to deliver its financing on the basis of its traditional business model of “sound banking” that requires adequate return for the risk the Bank takes.

- <u>Actions of central banks</u>

  The ECB and most of the non-Eurozone central banks in the region have adopted loose monetary policies with the aim to stimulate economic growth or avert deflation. In 2014 the ECB set a negative bank deposit rate, aiming to discourage the banks to keep excessive cash with the ECB and to stimulate lending; and announced an up to EUR 1 trillion Targeted Long-Term Refinancing Operations (TLTRO) programme, providing long-term financing to the banks for on-lending to the real economy. In the first quarter of 2015 the ECB expanded on these early measures by announcing a EUR 1.1 tn quantitative easing programme (QE) to support the general Eurozone economic recovery. Many other non-Eurozone central banks have adopted similar accommodative measures.

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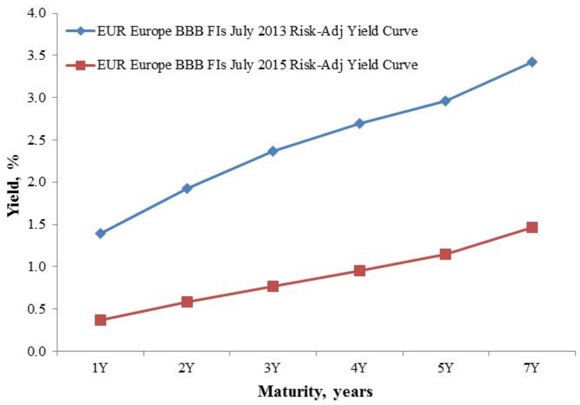
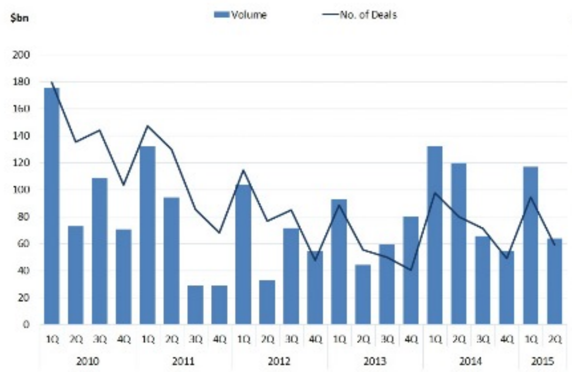
[4] “CESEE Deleveraging and Credit Monitor”, publication of the Vienna Initiative, 29 June 2015

[5] The expansion of private credit in Russia, Belarus and Turkey should be looked at in conjunction with the significant reduction of FDI (particularly in Russia); to a large extent the private credit expansion in all three countries in 2014 was in effect to “refinance” the reduction of FDI

In many COO these actions triggered contraction of the net interest margin, the core component of banks' profitability. The impaired profitability has affected banks' capital formation and, as a result, their ability to expand lending.

Another important consequence of these actions was a significant reduction of bond yields and base interest rates across the EU markets, with some of the base rates (Bundesbank's Basic Rate of Interest, short-term EURIBOR, LIBOR in Swiss Franc, Riksbank REPO rate) becoming negative. The yield contraction, stimulated by the accommodative central bank policies rather than by a fundamental reduction of the underlying risk, has reduced the attractiveness of financial institutions' term obligations and, as a result, the flow of private credit to European financial institutions. The two charts below underscore this observation. The chart on the left shows the two-year dynamics of the risk-adjusted yield curve for the BBB-rated European FIs (*source: Bloomberg*). The chart on the right shows the trend of senior bond issuance by European financial institutions (*source: Dealogic*).





Collectively the three macro forces, discussed in this section, represent a significant business development challenge for EBRD. In simple terms their impact in COO can be summarised as follows:

- Local corporates and small businesses hesitate to borrow long-term given the unclear business development prospects;
- As a result, local financial institutions generally find it more difficult to lend long-term, but even if the demand was stronger many financial institutions would struggle to meet it due to the tightened regulatory requirements, particularly concerning capital adequacy; and
- In the hoped-for scenario, where demand begins to pick up and strong capital cushions are in place, local financial institutions' lending capacity would continue to be affected by the limited availability of long-term wholesale funding as the combination of the interest rate environment and the new regulatory bail-in regimes have made the senior debt of financial institutions (particularly sub–investment grade) less attractive.

The main trigger to improve this situation would be the resumption of sustainable economic growth in EBRD COO. While it is probable that the accommodative policies of the central banks will help to restart economic growth, they will not address the fundamental structural problems which characterise many COO "stuck in transition". When external threats, such as the uncertainty of the success of Greek reform programme and increases in interest rates in the

USA, are factored in, it is clear that the overall operating environment will pose significant challenges for the implementation of the Strategy.

In many COO, the macroeconomic challenges described above are accompanied by specific local challenges that are either unique or are particularly acute in a given region or country:

- Capital constraints

  Insufficient bank capital is a widespread problem in COO. The primary causes, however, differ from country to country. The following table describes the three main causes, how they impact and in which countries they are most acute:

Primary cause for capital constraint	**How it affects capital**	**Most affected regions / countries**
NPLs and foreclosed assets	NPLs are the most harmful form of financial burden as they have a dual negative impact on financial performance – they attract higher capital charges and reduce banks' earnings (and by implication the natural capital formation). NPLs and foreclosed assets tend to be over-valued, over-stating the banks' capital. Banks tend to resist recognising such assets at fair value to avoid capital depletion. These assets therefore "clog up" the system for many years. In addition, NPLs consume human and operational resources that could otherwise be allocated to expanding new business.	Kazakhstan, the SEE region, Ukraine, Hungary, Cyprus Tunisia
Banks "locked-in" into unprofitable legacy products	Some banks (especially in the CEE and SEE regions), buoyed by the positive macroeconomic dynamics in the early 2000s, created large mortgage portfolios on the back of low funding costs. The problems have arisen where such assets had long duration. The changed macroeconomic situation and specifically funding costs in some cases made the economics of such mortgage portfolios negative, impacting the internal capital formation of the affected banks. Some of such low-yielding mortgage portfolios had been formed to take advantage of the positive FX dynamics between a local and a foreign currency (typically CHF) and were subsequently affected by the devaluation of the local currency. Because of the long duration of such portfolios banks usually have two choices: either to run them down or to sell. Selling would usually require a discount with immediate impact on capital. So most banks opt for the first option, which has a similar impact on capital but spreads it over a period of time. The negative side effect of that preferred route is that it requires continuous allocation of capital to support the portfolio while it matures and therefore restricts the ability of banks to continue to lend. Recent developments in countries such as Poland and Croatia, following on from Hungary which forced banks to convert the CHF-denominated mortgages in 2014, point to potentially large costs to the banking system from relieving borrowers of foreign currency risk on their mortgages.	CEE and SEE markets

Lack of new capital	The problem of carrying capital-eroding assets in many cases is exacerbated by the lack of new capital sources and unwillingness / inability of shareholders to put in new capital. Investing in banks no longer delivers the financial returns of the pre-crisis period, and even when asset quality is not an issue and growth opportunities exist, external investors and shareholders are much less willing to contribute new capital.	Not a universal problem, but exists in many COO

- Structural economic problems

While solutions to banks' capital constraints may be found on an individual basis, in many countries there will still be economic and market impediments to renewed financial sector growth. Addressing these impediments in many cases will require an integrated approach where financing is combined with intensive policy dialogue. The table below summarises the most important impediments in the transition region.

Structural economic problem	**Background and operation of the problem**	**Most affected regions / countries**
"Over-banked" markets	Some market players misjudged the expansion potential in some markets and grew too aggressively with the result that, at present, some markets arguably contain too many banks. The resulting intense competition has squeezed the lending margins and profitability. Currently, banks in such markets face existential questions and must choose between leaving the market, consolidating or finding sustainably profitable market niches.	SEE countries, some Central Asia and the Caucasus
Dominance of state-owned financial institutions	In some markets the state-owned financial institutions hold a significant market share and although in most cases they tend to operate on an arms-length commercial basis, their influence on the markets may distort the level playing field and reduce market competitiveness.	Russia, Belarus, Slovenia, SEMED
Underserved markets / market segments, e.g. female entrepreneurs	In some COO, penetration of banking services remains shallow and many active economic players continue to operate outside the formal financial sector. As a result, local economies in such markets remain under-funded, and can suffer from insufficient tax revenue and proliferation of informal market activities. In many COO this problem is particularly acute in the segment of female entrepreneurs. Large gender gaps in access to finance remain in all regions except for Central Europe and the Baltic states.	Central Asia, SEMED, Turkey, Azerbaijan, Macedonia, Kosovo Moldova
Investment climate quality	The quality of investment climate (which comprises the effectiveness of state institutions, rule of law, quality of legal and operating environments) has always been a factor for investors in COO. However, such considerations were often outweighed by the market growth potential; in the current environment the investment climate quality becomes a major deterrent for potential investors.	Ukraine, some ETC and SEMED markets

Under-developed capital markets	In most COO the local capital markets are not sufficiently developed to compensate for the reduction of financial intermediation in the banking sector and do not offer a viable alternative channel for long term financing to the real sector and to the banks themselves. Most COO lack the sound capital market infrastructure that fosters financial stability by facilitating the clearing, settlement and recording of transactions whilst adding to a market's liquidity. The absence of local institutional investors is also a common obstacle across the region.	Most COO
Major macro-economic shocks	Some COO have recently faced or are still going through major macroeconomic turbulence. Supporting financial institutions in such countries has been and will remain a focus of the Bank's financial sector operations.	Cyprus, Greece, Slovenia, Ukraine, Egypt
Local currency weakness	In some markets, lending to the real economy is constrained by the inherent weakness of the local currency. As a result, the prevailing lending rates in local currency can be prohibitively high. And while borrowing in a foreign currency may cost less at face value, there is a risk of a higher effective lending cost due to the local currency devaluation. Developing viable and sustainable solutions to this problem has been a key strategic objective of the Bank and led to the creation of a dedicated initiative (LC2) in 2012.	Serbia, Ukraine, some Central Asia and some SEMED markets

7. THE FINANCIAL SECTOR STRATEGY 2016-2020 – OBJECTIVES AND ACTIVITIES

7.1. The Financial Sector Strategy Objectives

The Bank's response to the described challenges faced by the financial sector is grouped into three ***strategic themes***, in line with the EBRD Strategic and Capital Framework 2016-2020:

1. Supporting resilient and efficient banks
2. Improving financial sector effectiveness and integration
3. Enhancing financial intermediation

The proposed ***strategic objectives*** of Bank's activities in the financial sector over the next Strategy period are derived from the strategic themes as follows:

1. **Supporting resilient and efficient banks**: The strategic objective will be to *contribute to the development of a sound banking sector through improvement of business standards, restructuring and consolidation, and increased competition*. This directly builds on the SCF medium-term direction of 'Building transition resilience'. The Bank's activities to achieve this strategic objective will be undertaken in conjunction with the Local Currency and Capital Market Initiative and the Investment Climate and Governance Initiative, and will also use the joint IFI platform provided by the Vienna Initiative.
2. **Improving financial sector effectiveness and integration**: The strategic objective will be to *strengthen the financial sector by achieving better diversification and integration into global financial markets through the improvement of local market infrastructure, local capital markets and local currency operations, the role of non-bank financial institutions and through product innovation*. This strategic objective is underpinned in the SCF medium-term direction of 'Supporting market integration'. The Bank's activities to achieve this strategic objective will be in conjunction with the LC2 Initiative, and will draw upon the work, analysis and recommendations provided by the Vienna Initiative.
3. **Enhancing financial intermediation**: The strategic objective is to *foster deeper and broader financial intermediation in COO through innovative financial products to reach under-served market segments and strengthen competition and market effectiveness in the financial sector*. This strategic theme is also consistent with the medium-term direction calling for transition resilience, stronger economic and financial inclusion and the need to address climate change and resource depletion, and for mainstreaming gender in Bank operations by 2020. Here again, the strategic objective will be achieved via the different strategic initiatives on-going within the Bank, especially the Small Business Initiative (targeting MSMEs), the Strategic Gender Initiative (targeting Women) and the Strategy for the Promotion of Gender Equality[6], the Green Economy Transition (promoting energy and resource efficient financial products), but also the Private Sector Food Security Initiative (which targets agriculture finance) and the Knowledge Economy where innovation and technological advancement are promoted.

[6] Approved by the Board on 9th December 2015, and is the Bank's guiding document in the area of gender during the implementation of the FI Strategy.

Each strategic objective is further broken down into a number of more specific ***tactical objectives*** to guide the practical implementation. These tactical objectives are further translated into specific ***activities*** that the Bank plans to undertake in the next Strategy period.

The following chart shows the relationship between the strategic challenges, strategic themes, strategic objectives, tactical objectives and main activities in more detail.

Strategic challenges	Strategic themes	Strategic objectives	Tactical objectives	Main activities
• NPLs and over-valued foreclosed assets • Banks locked in unprofitable businesses • Dominance of state-owned FIs • Lack of new capital • "Over-banked" markets • Strategic (i.e. existential) challenges of financial institutions	1. Supporting resilient and efficient banks	1. Development of a sound banking sector through improvement of business standards, restructuring and consolidation, and increased competition **(SO1)**	1.1. Strengthening market competition by supporting financially sound, efficient and actively growing financial institutions 1.2. Strengthening market competition by supporting privatisation and restructuring of financial institutions and market consolidation 1.3. Improving corporate governance and management standards 1.4. Developing financial solutions (such as risk-transfer solutions) to unlock the anaemic or dysfunctional banking sectors 1.5. Supporting the implementation of new technologies	• Equity and debt financing for strong banks with attractive and sustainable business models • Restructuring and re- / pre-privatisation equity investments • Transactions that facilitate NPL resolution • TA and policy dialogue
• Investment climate quality • Local currency weakness • Under-developed capital markets	2. Improving financial sector effectiveness and integration	2. Strengthen the financial sector by achieving better diversification and integration into global financial markets **(SO2)**	2.1. Development of non-bank financial sector as a viable alternative to bank financing, offering a wider range of products and services 2.2. Improving legal, regulatory, and institutional environment to support local currency transactions and capital market activity 2.3. Improving financial market infrastructure through policy dialogue and innovative financial solutions (e.g. supporting local deposit insurance schemes) 2.4. Support capital markets activity through capital markets debt and structured finance transactions	• Equity and debt for non-bank FIs • Capital markets and structured finance • Local currency denominated lending • Trade finance • TA and policy dialogue • New products
• Underserved markets • Lack of capital • Impaired ability of the banking sector to provide effective financial services	3. Enhancing financial intermediation	3. Foster financial intermediation in COO to reach under-served market segments and strengthen competition and market effectiveness in the financial sector **(SO3)**	3.1. Deepening financial intermediation, especially in underserved market segments 3.2. Promoting sustainable financial solutions to facilitate transition to energy efficient production and energy use 3.3. Support innovation and knowledge economy 3.4. Promoting economic inclusion and improving access to finance for MSMEs 3.5. Improved skills and investment in knowledge / technology	• SBI financing • SGI financing • GET financing • Mortgage lending • Trade finance • TA and policy dialogue • New products

7.2. The Financial Sector Strategy: Key Activities to Achieve the Strategic Objectives

As a foreword to the detailed discussion of the Bank's activities in the financial sector the sector outlook and operational implications are considered below.

- The financial sector environment in COO

  The macroeconomic headwinds discussed in the previous section are not expected to abate in the near future: most economies in the EBRD region are expected to continue showing sluggish growth for the next few years; the demand for term loans in the region will, therefore, remain subdued; the banks will continue deleveraging and contracting, making slow progress to relieve themselves of legacy NPLs; the banks will continue to build up capital for future growth, but realistically it will take several years for the banking sector in the region to return to the level where it can resume effective financing of the real economy. Given the slow economic recovery the region's central banks will continue accommodative monetary policies, depressing interest rates and keeping the long-term bank risk fundamentally unattractive to lenders from the risk-return perspective. IFI lenders are able, to some extent, to fill the gap in long-term funding and have been generally very active in playing that role, but the different mandates and different approaches of IFIs to the pricing of risk can constrain the EBRD's traditional role (*see more on the Bank's more active role in promoting "blended finance" below*).

  EBRD's activities in the financial sector will be calibrated to provide an appropriate response to these unique challenges. In addition to the traditional product range described below, in the next five years the Bank will emphasise the following strategic actions, which comprise activities that are new or so far have not been the mainstream activities of the Bank in the financial sector:

  - *Develop risk-sharing and NPL resolution*

    Both activities aim to address the supply of financing to the real economy by facilitating the reduction of the risk-weighted assets, proportionately increasing the capital adequacy of a bank and its ability to lend. Successful deployment of both activities (particularly NPL resolution) relies on coordinated action with other IFIs and cooperation with local regulators and governments. Policy Dialogue and IFI cooperation are expected to play a significant role in the Bank's efforts to implement these activities. (*See sections 7.2.5. and 7.2.7. for more information*)

  - *Promote and participate in re-privatisation of banks bailed-out by state*

    One of the legacies of the recent crisis has been an increase of state-owned or state-controlled banks, bailed-out by the respective governments during the crisis. Re-privatising such banks could provide an important impetus for the local economies to renew growth. In some COO the environment is sufficiently conducive to re-privatise the bailed-out banks and EBRD has already participated in a few prominent re-privatisation transactions in recent years – such as the sale of Citadele bank in Latvia to Ripplewood Holdings, the sale of Hypo Alpe Adria Bank to Advent International and the sale of NKBM in Slovenia to Apollo Global Management. The Bank's role is highly important and to a large extent catalytic in such transactions. It responds to the buyers' need to have a strong partner with expertise in the local markets and to the sellers' (i.e. local governments) need to have an "honest broker" in the relationship with the new majority owners of a bank. Under the new Financial Sector Strategy the Bank will continue emphasising this activity as a part of its overall effort to improve soundness of the banking sector across COO and facilitate lending to the real economy.

- *Advance the Bank's Strategic Initiatives through "blended finance" and competitive pricing*

  The combination of adverse macroeconomic trends, tightening financial sector regulation, accommodative monetary policies of the regional central banks and the expansion of concessional lending by some IFIs makes the operating environment in the region very challenging. In some markets it has become impossible for the Bank to continue delivering long-term financing through the local PFIs on the basis of its traditional business model of "sound banking". At the same time, as the financial institutions in the EBRD region play an important role of the "transition delivery agents", the Bank cannot be fully successful in advancing transition without a meaningful engagement with financial institutions in these markets.

  The Bank will respond to this challenge by intensifying its "blended finance" operations (where the financing delivered on commercial terms is combined with financial grants or incentives to stimulate a certain market behaviour of either the PFIs or their clients) and by allowing in targeted cases for financing to be priced on the basis of the prevailing market conditions[7], rather than on the basis of the implied risk. Bearing in mind its overall mandate the Bank will ensure that its actions are not undermining the sustainability of the economic recovery and growth in the region. EBRD will, therefore, apply these actions on a selective basis, primarily to the projects that demonstrate a clear link with the Bank's Strategic Initiatives –, SBI, LC2 and SGI. In connection with the latter, the Bank will specifically emphasise financing to support access to finance of female entrepreneurs through the new and already established financing programmes, such as Women in Business. Frequently such financing will be combined with technical assistance for partner banks to enable the expansion of financing for female entrepreneurs and for the end-borrowers to build their capacity to manage and grow their businesses.

  Specific emphasis will be made on supporting the Bank's efforts to address climate change and reduce carbon emissions through the Sustainable Energy and Sustainable Resources Initiative – especially as it is being scaled up into a Green Economy Transition Initiative. In this context the Bank will seek to expand the range of SEFF products to include: the promotion of best practice waste management and water efficiency; technical assistance and incentives to partner financial institutions and end-borrowers to encourage the adoption of the "green" technologies; and targeted policy

[7] For financial institutions in countries where the market benchmarks such as bond issues or CDS are unavailable or unreliable, the only market reference could be the average cost of funding of such financial institutions for liabilities of comparable maturity

dialogue on energy and resource efficiency, renewable energy development and efficient water and waste management policies.

- <u>Structural and strategic changes in the financial sector</u>

  The combination of the deteriorated macroeconomic environment and regulatory changes will fundamentally change how banks operate in the future. The traditional "generalist" banking business model may come to be perceived as less effective as financial institutions are forced to adjust to a slow growth environment, tougher competition and higher costs. Against this background, achieving and sustaining an acceptable level of profitability becomes the main strategic priority for banks across the transition region.

  Banks will become more selective about their core markets, customer segments, business lines and products, while technology will become a critical success factor. The financial sector significantly lags behind many other industries in terms of technological innovation. Smart business re-engineering and technological investments are likely to be one of the main value drivers of the future business models of banks. There is already evidence (so far mostly limited to the developed markets) of new players entering the sector and introducing technology-driven new business models that will challenge the established traditional banks.

  The evolution of the financial sector in recent years has indicated that the non-bank financial institutions are set to play a much more important role in the operation and development of the global financial markets. The trend is particularly strong in the developed markets, but is also becoming evident in the COO. Here again the technology-driven institutions that offer novel and more efficient ways of consuming financial services or accessing financing are leading the way. The most frequently mentioned examples of such financial institutions are peer-to-peer lending platforms and virtual banks. The long term viability of this nascent area of the financial sector is yet to be proven, however it has already attracted a significant number of customers and investors.

  In response to these strategic and structural shifts within the sector the Bank will undertake in the next five years the following strategic actions:

  - *Selectively engage with "challenger" banks*

    The financial sector evolution in the recent years indicates that the banks that employ technology to adopt innovative business models, currently labelled as "challenger banks" are likely to become mainstream in a near future and over time possibly establish a new standard of banking. EBRD has a successful track-record of financing such banks (Alior Bank and Meritum Bank in Poland) in the recent past and, recognising the growing importance of this segment, will seek to deepen its engagement with the "challenger" banks in the context of the new Financial Sector Strategy. It is important to note, however, that such engagements would be inherently risky and the Bank will have to carefully weigh the risks against the commercial and transition benefits in building up its exposure to "challenger" banks.

- *Engage more actively with non-bank financial institutions*

  The main focus of the Bank's engagement in the segment of non-bank financial institutions will be on: i) addressing significant market gaps (for example, engaging with NPL management or NPL buy-out companies to facilitate the NPL resolution in certain markets); ii) facilitating the advancement of the Bank strategic initiatives (for example, engaging with a market infrastructure company or an asset management company in the context of the LC2 initiative, engagement with an MFI to expand their MSME lending operations under the SBI, or engagement with a leasing company to promote financing of energy efficient equipment under the GET); and iii) market expansion and facilitating market competition by engaging with established market players (for example factoring companies, asset managers and insurance companies).

  In connection with the Bank's LC2 initiative and the strategic objective of improving the financial sector effectiveness and integration, EBRD will seek to expand its client universe beyond exchanges and central clearing counterparties to include other types of companies that are critical for the effective operation of the markets such as credit information providers, payment infrastructure providers and servicers and independent risk management platforms.

  On a selective basis the Bank will also look to develop "non-mainstream" types of projects with non-bank financial institutions that offer significant transition impact potential. Examples of such projects may include investments in start-up non-bank financial institutions or support for operations in the "shadow banking" sphere, but it should be noted that such operations tend to require venture capital support and are inherently riskier than regular financial sector operations.

Please see Annex 3 for more information on the general Bank approach to selecting PFIs.

The following sub-sections (7.2.1 – 7.2.8) detail the main activities of the Bank during the new Financial Sector Strategy period. In contrast to the top-down approach to analysis and presentation in the preceding sections, this section is presented in a bottom-up format, which better reflects the Bank's business model and will help in tracking the Bank's achievements via its investment projects and other activities during the implementation of the Strategy. To show the linkage between the activities (i.e. financing activities and policy dialogue) and strategic objectives ("SO"), in this section each activity is referred to the relevant strategic objectives and, where applicable, the relevant Bank strategic initiative.

7.2.1. Senior Debt

Senior debt to financial institutions has been the core financing instrument of the Bank and should remain in demand due to the limited availability of long-term senior debt in almost all COO. This demand is, however, tempered in many COO by the excess liquidity in the banking sector and absence of loan growth which, if it continues, will make banks less willing to pay the margins associated with term lending. This will be a critical challenge to the Bank over the coming years as the Bank's senior debt to financial institutions has played the important role of a transmission tool, facilitating EBRD's transition agenda in the region and the Bank's core strategic initiatives. The Bank's senior lending under the new Financial Sector Strategy will continue to advance the transition agenda and strategic initiatives with a particular focus on:

- *Providing long-term debt financing to strong financial institutions*

  Such investments would aim at improving market competition and market effectiveness by providing long-term debt financing to strong financial institutions that have demonstrated soundness of their business models; this activity would be in support of the Bank's SCF (SO 1).

- *Better access to finance of underserved customer segments*

  The strategic objective of such activities would be to deepen financial intermediation through economic inclusion and provision of better access to finance of underserved customer segments; this activity would aim to advance the Bank's SBI (SO 1&3);

- *Expand financing to female entrepreneurs*

  Women in Business Programmes facilitate economic inclusion by expanding financing to female entrepreneurs in conjunction with the Bank's SGI and the future Strategy for the Promotion of Gender Equality (SO 3);

- *Sustainable Energy Financing*

  Promoting financially sustainable investing in energy efficient production and energy use would implement the Bank's GET (aiming to achieve SO 1&3).

- *Promoting local currency lending, particularly focusing on affordability and commercial viability of local currency lending (SO 2&3)*

  The Bank's efforts will be guided by a long-term perspective of achieving sustainability of local currency funding in a given market rather than merely on provision of local currency financing for specific projects. To this end, policy dialogue will continue to play a critical role in addition to the provision of local currency financing under the LC2 initiative.

In addition to the listed main focus areas of the Bank senior lending in the financial sector will continue pursuing other forms of senior lending that have significant transition impact potential. Examples of such financing could include: a standby debt arrangement in support of local deposit insurance systems; financing to support the introduction by a PFI of new technologies to innovate client acquisition or operational management; acquisition financing in support of market consolidation.

7.2.2. Capital Markets and Structured Finance

Investing in financial institutions' senior and covered bonds and participation in arranging and investing in structured finance transactions (such as Asset Guaranteed Bonds and securitisations) are envisaged to become more mainstream activities of the Bank. These activities will be aimed at achieving the strategic objective of strengthening of the financial sector through diversification and integration into global financial markets (SO 2) and at promoting the Bank's LC2 strategic initiative.

Since achieving a critical mass (of the market size) is critically important for the development of the capital markets the Bank will continue emphasising this activity in the countries where the capital markets development is one of the primary objectives (EU countries and Turkey).

7.2.3. Trade Facilitation Programme

As noted above, the Programme remains as relevant as ever in the region and continues to deliver important transition impact and high additionality.

Under the new Financial Sector Strategy TFP will pursue the objective of deepening financial intermediation and enhancing the breadth of financial sector instruments in a particular country (SO 3). In line with this objective TFP will increase its focus on countries and market segments where its activities are highly additional – ETC, SEMED and smaller regional players in more developed markets. The Programme will continue working with larger well-established counterparties in countries with substantial transition gaps, where such large players traditionally provide nation-wide outreach to MSMEs.

TFP products will continue to be deployed in markets that suffer systemic disruption, with traditional channels of financing severely distressed – the situation presently seen in Ukraine, Greece and Cyprus. In such situations the Programme will play a highly additional role of supporting international trade flows.

The Bank will explore opportunities to further deepen financial intermediation through the Programme by introducing new products (e.g. Green TFP), enhancing existing products and expanding operations geographically with a focus on more challenging regions (SO 2&3).

7.2.4. Equity Investing

Equity investing is the most impactful activity of the Bank. Under the new Strategy a renewed emphasis will be on investing to improve the resilience of existing banks, participate in the restructuring of the banking sector, influence improvements in financial sector and market infrastructure, and act as a catalyst for the development of the non-bank financial institutions which can play a pivotal role in expanding and strengthening the financial sector.

Examples of such investments would include:

- *Investing in a financial institution potential or proven market consolidator (SO 1&2)*

  Such investments would have particularly strong impact in "over-banked" / contracting markets and markets that undergo restructuring.

- *Pre-privatisation equity investments or investments at privatisation to facilitate better market competition (SO 1)*

  Such investments would be most impactful in markets with a significant share of state participation and would aim to strengthen market competitiveness.

- *Investing in a financial institution going through a restructuring with an anticipated outcome of the institution emerging as a strong market player (SO 1)*

The strategic objective of such investments would be improving the health of the financial sector in COO. In some such situations EBRD may play the role of a "catalyst" investor, encouraging private capital to participate in recapitalisation of capital-constrained but otherwise viable financial institutions.

- *Investing in a financial institution that plays an important systemic role in the market infrastructure (SO 2)*

  Such transactions may include investing in a country stock-exchange, a clearing house or other types of financial institutions that support the market infrastructure and through the investment would aim to make a significant contribution towards improving the financial sector infrastructure in a particular country. Often such investments would be accompanied by intensive technical assistance and policy dialogue activities (see below).

- *Investing in a financially sound financial institution operating in a fast growing market or market segment (SO 3)*

  The "traditional" investment activity for business expansion will be pursued, with a view to developing role models and best practice institutions in the region through the transfer of skills and enhanced corporate governance.

In its equity investment operations the Bank will put a stronger emphasis on value creation through more intensive engagement with the client and its key shareholders at the stage of transaction structuring, but even more so post-signing through the work of the nominee director and more hands-on management of the portfolio.

7.2.5. Capital Support Instruments

In addition to equity investing, the Bank will continue exploring hybrid and structured debt instruments to attain the same strategic objectives as equity investing. Examples of such activities would include:

- *Risk-transfer (or risk-sharing) solutions (SO 1&3)*

  The Bank is pursuing financing solutions that would provide local banks with long-term debt funding and capital relief at the same time. The objectives of such projects would be to assist a viable bank in rebalancing its balance sheet or/and promoting the launch or expansion of new products targeting under-served market segments. There is strong demand for such solutions in the region, but it has not yet been possible to develop a financing model that would appeal to commercial investors or would be fully sustainable on a commercial basis in COO. Financing arrangements containing grant components have been and, at least in the medium-term, will remain the most feasible model to develop such instruments on a meaningful scale.

- *NPL solutions via investment/purchase of bank's assets (SO 1&2)*

  Unlike other forms of risk-sharing where the assets typically stay on the balance sheet of the selling financial institution, NPL solutions typically require an outright sale of the assets for cash. This has proven to be a stumbling block to successful deals, mainly due to a persistent valuation expectation gap between the asset sellers and buyers.

The Bank will continue exploring NPL solutions and will test various structural enhancements that may help overcome impediments, in close conjunction with intensive policy dialogue to be conducted directly with governmental bodies in the context of the Vienna Initiative (*see below*).

- *Investment in asset securitisation (SO 1&2)*

  Asset securitisation has re-emerged in some COO and, as it proves itself again as an investible instrument in the post-crisis environment, can facilitate efficient balance sheet management and capital allocation. Some countries have become asset-securitisation friendly, but in many the legal framework is not sufficiently robust to support these structured transactions, nor is investor appetite established. There have also been regulatory changes that introduced higher capital charges for securitised assets and made holding such assets more expensive. There are indications of a thaw in attitude from the regulators towards asset securitisation, especially in relation to MSME assets, which may open up viable business opportunities for EBRD.

- *Hybrid and subordinated debt (SO 1)*

  Hybrid and subordinated debt can be a useful funding instrument due to the combination of debt and equity features in its structure, but its misuse, exposed during the financial crisis, has triggered a more rigorous approach to its treatment by regulators. However, with large capital needs ahead for banks, there is a place for such instruments in the capital structure to bolster their resilience and enhance their efficiency. Commercially viable structuring solutions will continue to be explored, seeking the appropriate balance between risk and reward.

7.2.6. Grant Funding and Technical Assistance

The Bank has historically delivered technical assistance in conjunction with its financing projects, an approach that has proven to be an effective way of gaining the counterparty commitment to required institutional improvements. Under the new Strategy the project-driven TA will continue to support the main activities of the Bank to achieve the tactical and eventually strategic objectives outlined above. "Stand-alone" projects will play an important role in situations where a beneficiary of TA demonstrates a strong commitment to improvements.

During the new Strategy period, TA activities are expected to be focused on the following:

- *Improving business standards through institution building and transfer of skills*

  As a "mainstream" activity of the Bank, TA to improve corporate governance standards and transfer of skills will continue playing an important role in development of institutions in the region. The emphasis will be on the areas which the crisis exposed as lacking in quality, consistency and sophistication:

  - Risk management
  - Corporate governance
  - Corporate strategy

  - o Operating efficiency
  - o Knowledge transfer (e.g. partner bank training in connection with the TFP, partner bank training in connection with financing for female entrepreneurs to facilitate understanding of the women-led MSME market)

- *Deepening financial intermediation and improving business standards through GET*

  The technical complexity of the GET lending programmes requires intensive expert involvement. The expert advice is delivered: i) in-house by the Bank; and ii) by external consultants who are financed through Technical Co-operation funds. Under the new Strategy, the GET lending and the corresponding technical assistance will remain one of the main activities of the Bank in the financial sector.

- *Supporting the development of new business activities and financial products*

  Development and implementation of new and innovative financial solutions under the SBI and other strategic initiatives will often require expert advice, a significant share of which will have to be delivered through the technical assistance projects.

  The grant intensity of the EBRD's financing activities in the financial sector will continue to rise driven by the strong volume of the SEFF business and the development of innovative financing solutions mentioned above. These new financial solutions will aim to address the identified market failures and deficiencies: unresolved non-performing assets; lack of new lending for SMEs in general, but in particular for "high-risk" SMEs such as innovative and start-up entrepreneurs, female entrepreneurs, agricultural entrepreneurs and entrepreneurs in smaller / remote areas. In most instances these solutions will be new and untested in particular markets and will, therefore, require grant financing to support their initial deployment and evolution, putting stronger emphasis on the effective management of donor relationships and IFI cooperation.

7.2.7. Policy Dialogue

Policy dialogue will play an ever-important role in helping the Bank to achieve the Financial Sector Strategy's objectives, in line with the recent reorganisation and enhancement of the Bank's policy dialogue delivery via VP3. The Bank's intimate knowledge of the challenges faced by the financial sector in the COO, its strong relationship with financial institutions and successful track record of engaging with authorities to support key policy reforms will provide a solid platform for policy dialogue activities under the new Financial Sector Strategy.

As per the *Enhanced and Structured Approach to Policy Reform Dialogue at the EBRD* paper[8], investment projects will continue to form an essential base for a more proactive EBRD policy reform engagement ('bottom up approach'). Policy dialogue will continue to be prioritised based on the operational priorities of the Bank in the financial sector, leveraging EBRD's unique value proposition of a provider of the long-term financing and an effective intermediary between the private and public sectors.

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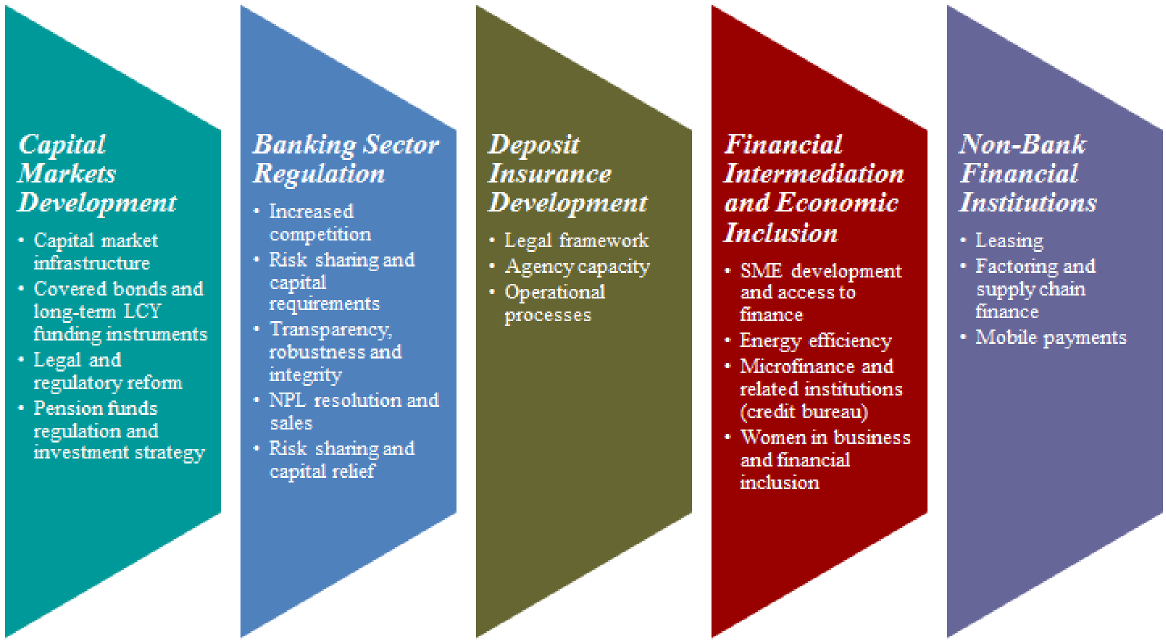
[8] EX15-152, dated 21 July 2015.

Being an investor provides the Bank first-hand *understanding* of the challenges faced by the sector, and also the opportunity to *demonstrate* the positive impact of policy reform through investments. However, this can also put the Bank in a position where the reform it advises upon could benefit the Bank's own investments, which could act as a bias (actual or perceived) in the policy advocacy. Special care will thus be taken to manage the actual or perceived bias or conflict of interests in the Bank's policy dialogue projects, in particular by ensuring the policy advice is given at arm's length by another team within the Bank, by ensuring a wide consultation process within the country (where other interests can be heard and recorded) and also by closely cooperating with other IFIs, the EU and bilateral development organisations to ensure that balanced policy messages are delivered to the relevant authorities.

Under the new Financial Sector Strategy, policy dialogue will be prioritised to enhance the impact on the local economy and new business opportunities, based on the Bank's analysis by country (in the form of in-depth Country Diagnoses) and by sector, and reflected in the relevant Country Strategies, which would clearly identify the policy dialogue work to be undertaken and measured through the respective Results Frameworks. Taking stock of the lessons learned from policy dialogue undertaken by the Bank so far, the activities will include support to policy implementation in addition to the definition or redefinition of policy.[9]

Policy dialogue will focus on the following key areas as shown in the diagram below:

Policy Dialogue Priorities for Financial Sector (2016-2020)



[9] See *The EBRD's experience with policy dialogue in Ukraine*, Special Study, EBRD Evaluation Department, April 2014, section 5.1.9.

Each area is examined in detail in turn below.

- *Capital Markets Development*

As per the strategic objective of improving the financial sector effectiveness and integration (SO 2), the Bank will focus its dialogue with policy makers on topics that are of fundamental importance for the development of capital markets:

- Capital market infrastructure. The Bank will engage with stock exchanges, clearing houses / central counterparties (CCP), trading platforms and central securities depositories to help these institutions strengthen their operations, address legislative obstacles that prevent market development, and share and encourage best practices by the relevant stakeholders. It is essential that the capital market infrastructure is aligned to the development stage of the capital market by offering an appropriate level of services and functions as well as simple, reliable and cost efficient access for issuers, trading and clearing members, and investors. For example, discussions are ongoing regarding the feasibility of converting an existing national CCP (for example, in Hungary, Poland or Greece) into a regional one and to ensure third party recognition with other CCP such as Euroclear. A number of stock exchanges in the COO are undertaking a 'de-mutualisation' process which would enable the entry of a strategic investor in their capital, paving the way for a restructuring and review of their strategy. The EBRD would be well placed to advise and share best practices in this process.

- Covered bonds and long-term LCY funding instruments. The Bank will encourage or support reforms to promote the issuance of long-term local currency funding instruments and to provide a platform to discuss and effectively resolve any misalignment between the private sector needs and constraints or concerns of the public sector. For example, the Bank has recently launched a project to support the Ministry of Finance of Croatia in developing a Covered Bond Law. The Bank has been involved in Poland, commenting on the reform of the covered bond legal and regulatory framework with the view of removing or smoothing out the impediments that have so far prevented this market from developing to its full potential.

- Legal and regulatory reform. The Bank's expertise can be mobilised to advise COO on the upgrading of securities laws and other capital market regulations to provide a framework conducive to listing and trading, whilst ensuring fairness and transparency (e.g. insider dealing provisions, bondholders enforcement rights, etc.). This also includes work on covered bond and other debt instruments, as mentioned above.

- Pension fund regulation and investment strategies. Whereas discussions around the fundamental structure of pension fund (in particular Pillars 1 to 3) tend not to be within the remit of the Bank, the Bank can play an important role in engaging with regulators on effective ways to regulate pension funds to ensure that their funding, sustainability, and investment strategies are suitable and that they can effectively act as a key capital market investor.

The work will necessarily evolve together with the on-going regulatory developments taking place globally and at the European level.

- *Banking Sector Regulation*

Being of particular importance in countries where the banking sector is under stress or in need of deep restructuring (*see above Section 6*), this policy dialogue will aim to improve general resilience of banks in the face of future market shocks and disturbance and could complement potential investments under the strategic objective of supporting resilient and efficient banks (SO 1). To address the widespread strategic challenge of constrained capital EBRD will engage with regulators in various COO to explore how some innovative products could qualify as capital relief for the banks, which will in turn also support the strategic objective of fostering deeper financial intermediation (SO 3).

Under the new Financial Sector Strategy, it is envisaged that policy dialogue will address, inter alia, the following issues:

- Fostering competition in the banking sector through restructuring or privatisation. The Bank will engage in discussions with local authorities to discuss the benefits that privatisation or entry of strategic investors into the capital could bring to the banking sector as a whole. This is particularly important in countries like Tunisia, Morocco or indeed Turkmenistan where state-owned banks dominate all or part of the financial sector. The Bank will share its experience in assisting with the restructuring of state-owned banks and provide if appropriate independent expertise for structuring and conducting effective disengagement of the State and assistance in designing the corporate governance framework for the newly reformed or privatised banks.
- Transparency, robustness and integrity of the banking system. By engaging with the local authorities through technical assistance EBRD will aim to contribute to improving the banking system on the key identified weak areas. For example, the Bank will continue to advocate in Moldova the establishment of a single, unified, universal and transparent registry of shares of banks[10]. In Ukraine, the Bank currently assists the Central Bank in establishing a programme for the restructuring of the banking sector, including the development of an out of court NPL resolution framework.
- NPL resolution and sales. The sale of non-performing loans can be a very effective way to help the banking sector resume lending, but these transactions are highly dependent on the environment in which they would take place. The work will entail discussing the obstacles to distressed debt sale (retail and corporate) with the authorities and facilitating dialogue between the authorities, banks and potential investors to find effective solutions enabling distressed debt transactions. This work will build upon on-going efforts (such as the Kazakhstan NPL Platform that the Bank is supporting) and will be undertaken under the coordination mechanism of the Vienna Initiative, which includes large international banking groups active in Central and South Eastern Europe, local regulators, IFIs and EU institutions. In additional, the Bank will also ensure that the legal framework for debt

[10] This issue is included in the ICGI work programme in Moldova.

restructuring and liquidation/foreclosure is modern and efficient, and balances appropriately the rights of debtors and creditors. For more detail, see the box below.

Case Study: EBRD and NPL Resolution – the example of Hungary

Hungary has been grappling with high levels of NPLs since the onset of the financial crisis in 2008, in both the retail and corporate sectors. This has remained, like in many other countries of Central and South Eastern Europe, the principal factor impeding a credit recovery (as evidenced from the *VI Bank Lending Survey in CESEE* carried out by the European Investment Bank in June 2014). After a few years of inertia, the country authorities but also banks (and foreign parent banks), investors, the ECB and IFIs (IMF, World Bank and EBRD) have started to discuss how solutions could be designed. Under the auspices of the Vienna Initiative and its NPL Resolution Platform, the EBRD together with the Central Bank of Hungary undertook in 2014 a review of the legal, regulatory, fiscal and accounting obstacles to corporate restructuring and insolvency. This impartial and expert analysis revealed that the insolvency law presents major defects, in particular with regard to the lack of 'pre-packed' reorganisation procedures, ability of creditors to propose or amend reorganisation plans, and generally consultation and decision-making rights for creditors in insolvency proceedings. The transfer of NPLs to investors is also hampered by the licensing requirement for entities purchasing NPLs, which appear to be unduly heavy. In addition, the transfer of loans could jeopardise the validity of the security attached to loans (collateral). Finally, banks can only write off loans after a long period has elapsed (typically following a liquidation procedure, which may take 2-3 years), which acts as a disincentive for banks to tackle their NPLs swiftly. Using the review, the Central Bank was able to reach out to the Ministry of Justice, Ministry of National Economy and Ministry of National Development to agree on a work plan of reforms. This work, to take place in 2015-16, will be supported, among others, by the EBRD.

- Risk sharing and capital relief. The Bank will undertake dialogue with COO central banks and other relevant ministries on the capital treatment and the regulatory environment of risk sharing products with a view to achieving an enabling environment where the Bank and other investors can offer such products to financial institutions. This is currently on-going in Serbia and Georgia but is likely to extend to other COO.

- *Deposit Insurance Development*

This subject is closely related to the strategic objective of improving financial sector effectiveness and integration (SO 2). As bank failures have the potential to trigger a broad spectrum of harmful events, including economic recessions, the local governments maintain deposit insurance schemes to protect depositors and to give them confidence that their funds are (to a degree) safe in the banking system. The deposit insurance schemes have become more complex but also even more relevant since the last financial crisis, as a number of deposit insurance agencies saw their mandate expanded to include resolution tools in addition to depositors' reimbursement. The Bank will continue building upon the previous successful projects in Albania and Serbia (see below the case study). It is envisaged that in the next Strategy period the need for this policy dialogue will remain strong, especially in the countries that are in the process of implementing the 2014 EU Bank Recovery and Resolution Directive (e.g. Bulgaria and Croatia), and where there is a need to upscale or reform the outdated deposit insurance mechanisms (e.g. Tunisia). The activities could address i) the legal framework; ii) the agency capacity to operate; or iii) operational processes, depending on the needs on the ground.

Case Study: EBRD's support of the Albanian and Serbian Deposit Insurance Schemes

In 2013 the Albanian Deposit Insurance Agency (ADIA) approached EBRD for technical assistance to design, develop and implement a new IT system to allow the automated collection of data on depositors' accounts of local banks for the accurate and expedient calculation of the insured depositors amounts. This was to facilitate reporting to the Central Bank and accurate payments to depositors in case of a bank's collapse. The upgrade of the IT system was also required due to changes in the Albanian deposit insurance legal framework. The EBRD provided the necessary technical expertise to carry out this work, which still continues today.

In Serbia, in 2013-2014 the Bank provided support to the Serbian Deposit Insurance Fund (SDIF), which had been depleted after the failure of several local banks. The Bank's project consisted of: reviewing the institutional and organisational structure of the Fund; facilitating the definition of its legal mandate; reviewing the existing financial model of the Agency managing the Fund; assessing the bad asset portfolio managed by the Agency and advising on the portfolio value maximising strategies. After successfully completing the advisory work, EBRD provided to the Serbian Deposit Insurance Agency a stand-by financing facility of EUR 200m. An institution capacity building programme is still on-going at the SDIF.

- *Financial Intermediation and Economic Inclusion*

As mentioned in the previous section, economies with underserved financial sectors do not perform to their full potential and are often associated with informal market activities and lost tax revenues. In response to this challenge, the Bank has been promoting economic inclusion primarily through stand-alone technical assistance and policy dialogue projects such as technical assistance for women entrepreneurs to enhance business skills and ETC Financial Inclusion Project to bring migrant workers' remittances into the formal banking sector. In the next Strategy period, policy dialogue will continue to further support the Bank's effort to promote deeper financial intermediation and economic inclusion (SO 3), and will focus on:

- <u>SME development and access to finance.</u> The Bank will, working closely with partner organisations, determine the obstacles to SME development and access to finance that can be addressed via policy changes and engage with governments and central banks to address such obstacles, including those specific to women-led MSMEs and other gender dimensions of investment climate reform. This will consist of promoting and improving the laws and institutions instrumental to effective SME lending, such as secured transactions and collateral registers, creditors' rights and enforcement (foreclosure), and SME lending regulations (which in some countries may include interest-rate caps). Collateral reform, for example, is already on-going in Morocco and Tunisia, and has been discussed for some time already in Mongolia and Turkmenistan. As many COO have already achieved a number of key reforms, it will be essential to review carefully the existing legal provisions and the way they have been implemented in order to establish what measures could be introduced that would truly impact on SME lending. This work – typically surgical – requires a deep understanding of the market that the Bank is very well placed to facilitate.

- Energy efficiency. Policy dialogue in this field will build upon existing and successful programmes to address the regulatory environment around energy efficiency in order to make financial products in this area meaningful and commercial viable. For example, work is on-going in Turkey on assisting the authorities in transposing of the EU Directives on Energy Efficiency, introducing resource efficiency into a National Plan, and providing a national roadmap for Energy Efficiency investments and policy adoption. This work paves the way and provides the backdrop for the energy efficiency credit lines that the Bank has launched in Turkey with a number of participating banks.
- Micro-finance. The Bank will engage with the regulator and/or the government on the regulation (or lack of) of micro-finance and assist with the drafting or amending a micro-finance law to make the regulatory regime conducive for effective operation of microfinance institutions, and in some cases their graduation into deposit-taking institutions or extension of their services (micro-savings, micro-insurance, etc.). Whenever requested, the Bank will also assist in improving the financial infrastructure enabling sound micro-finance lending (e.g. credit bureaus).
- Women in business and financial inclusion. Under this heading, the Bank will address through carefully selected projects, obstacles to women entrepreneurs access financing services, and more generally promote a deeper access to financial services across its COO. For instance, the Bank could seek to promote the use of remittance inflows as acceptable collateral for loans to female entrepreneurs and micro loans in general. As a member of the IFI Financial Inclusion Working Group, the EBRD will coordinate with its partners to ensure that the projects are maximising the comparative advantage of the Bank.

- *Enhancing the Role of Non-bank Financial Institutions*

Under the strategic objectives of improving financial sector effectiveness and enhancing financial intermediation (SO 2&3) the Bank will aim to support the development of established non-bank financial institutions and the evolution of the nascent non-bank financial service companies. The development progress of both types of institutions is often impeded by ineffective legislation or the lack of conducive regulation. The Group has identified the following priority segments of the financial sector where the policy dialogue can help unblock the development of non-bank financial institutions:

- Leasing. The scope of policy dialogue activities here would include the regulatory environment and the legal framework underpinning leasing activities (both operational and financial).
- Factoring. The policy dialogue could address the regulatory regime applicable to factoring companies but also the instrument itself, which often suffers from a too rudimentary definition. In addition, supply-chain finance (also known as 'reverse-factoring') will be explored: this financial service permits a (usually large) buyer and its suppliers to work together with a financier in order to optimize supply chain finance (assuming that the buyer

enjoys a lower short-term borrowing cost than its suppliers). Under pre-agreed conditions the buyer accepts the supplier's invoice confirming the supply of goods and transfers it to the financier, who pays the supplier discounting the invoice amount for an early payment rate based on the buyer's credit standing and thus becomes an invoice creditor against the buyer. Reverse factoring would typically lower the costs of working capital financing for SME and allow financiers to offer non-recourse product as the risk management is streamlined. The development of an on-line platform (as was done in Mexico) can further reduce overall costs and increase competition between financiers.

- Mobile payments. The policy dialogue work on mobile payment often involves the telecoms regulator as well as the Central Bank to ensure that the framework in place promotes financial services to be offered and operate on a transparent and secure basis.

These priority segments will also support financial intermediation and economic inclusion (see above). Where possible the Bank will align its policy dialogue activities in this area with its investment projects to enhance the likelihood of a positive outcome and effectiveness of the policy dialogue.

Policy Dialogue is not an activity that the Bank undertakes in isolation and this will be no exception in the context of the new Financial Sector Strategy. The Bank will, as much as possible, leverage on cross-conditionality, referring to other IFIs' investments loans or financing programmes for budgetary or balance of payment support, such as the IMF/ World Bank's Financial Sector Assessment Programs, which are explicitly conditioned on policy changes.

Closer strategic alignment with the relevant association and other similar agreements of the European Union, such as the EU Instrument for Pre-Accession (IPA) or Deep and Comprehensive Free Trade Agreements (DCFTA), provides the right backdrop for policy reform and the Bank will, as it has done in the past, leverage these agreements to build political consensus within the COO and agree on specific reforms. However, the main leverage of the Bank, and its comparative advantage, will remain its unique ability to mobilise private sector clients and financing to raise awareness of the local authorities and exercise pressure for reform, and the Bank will continue utilising this comparative advantage in the context of the new Financial Sector Strategy 2016-2020.

7.2.8. Linkage between the Financial Sector Strategy and the Country Strategies

In addition to the cross-cutting strategic actions which, as discussed in the section 7.2, will aim to address some common structural challenges in the financial sector across the region, the Bank's regular (project-based) financing and policy dialogue activities will be calibrated towards the specific regional challenges in the financial sector as identified by the relevant Country Strategies:

- in the Central Europe, the EU SEE countries (Bulgaria and Romania) the Baltics region and in Turkey the Bank will concentrate on facilitating the development of local capital markets and local currency lending through the combination of financing activities and policy dialogue;

- in the SEE countries in general the Bank's operational focus will be on the expansion of lending in support of the GET through SEFFs and on the recovery of lending to the real economy through the development of risk-transfer solutions to resolve the problem of constrained capital and high NPLs of local financial intermediaries; policy dialogue activities will focus on improving banking sector regulation, effective financial intermediation and enhancing the role of non-bank financial institutions;
- in the CIS countries, the Caucasus, Ukraine and SEMED, the focus will remain on deepening financial intermediation, in support of the Bank's Small Business and Strategic Gender Initiatives, through senior lending and specialised financing programmes, such as Women in Business, Competitiveness Financing Facility and Agricultural Financing Facilities; the main focus of the policy dialogue in these regions will be on effective financial intermediation, economic inclusion and on improving banking sector regulation;
- in Cyprus and Greece the operational focus will be on facilitating the restructuring of the local banking sectors and revitalising lending to the real economy by local financial intermediaries.

Such priority activities do not mean to be exclusive and prevent the Bank from deploying other financial products and policy dialogue activities that are relevant in the context of a particular financial sector challenges. Therefore, the priority activities will be complemented by other relevant activities in the financial sector either to enhance the impact of the priority activities or, in cases where the delivery of the priority activities remains challenging, as an alternative means to achieve the same strategic objectives. The few examples below illustrate this concept.

- In Kazakhstan the operational focus will be on developing and implementing an effective country-wide NPL resolution mechanism. However, a significant period of time will be required to develop such a resolution mechanism on a technical level and achieve support of all relevant stakeholders. In the meantime the objective of deepening financial intermediation in the country will require the Bank to continue supporting the provision of financing to MSMEs via financial intermediaries in Kazakhstan.
- In Turkey, Poland, the EU SEE countries and other Central Europe countries in addition to the priority of developing local capital markets there remains significant scope and need to continue supporting the provision of sustainable energy financing through local financial intermediaries.
- In some Eastern Europe countries (particularly Ukraine and Moldova) the provision of financing to small businesses via local financial intermediaries should go hand in hand with continuous efforts of the Bank to strengthen the local banking system through the policy dialogue and bank restructuring / turn-around equity investments.
- In Greece and Cyprus restructuring of the banking system and revitalisation of lending to the real economy is the priority task, but similar to the Kazakh NPL resolution it is a long-term task. In the meantime the cross-border trade between these countries and the rest of the world remains impaired due to the inability of local banks to provide adequate financial support, making the Bank's TFP highly relevant.

The Bank's strategic objectives and operating priorities in the financial sector will over time change the composition of the portfolio. While the volume of the new business for the financial sector will develop in line with the overall volume of the Bank's new business, the varying operational focus on the main strategic challenges in different countries will drive the change in the portfolio structure. The Bank's risk appetite and the evolving political and economic environment will also play a key role in shaping the structure of EBRD's portfolio in the financial sector. The following would be the likely trends in a medium term, subject to changes in the environment and Bank priorities.

- The Bank will accelerate the development of new business in SEMED with a focus on SBI, SGI and GET, while deepening the relationships with existing PFIs and expanding the universe of partners at the same time. The share of the Bank's exposure to financial institutions in the SEMED region would continue to expand.
- The Bank will continue to develop operations in Turkey at the pace seen in the previous years, with a continued strong emphasis on additionality and transition, prioritising activities associated with the Bank's strategic initiatives (particularly SBI, GET, LC2 and SGI) and equity investment activities in financial sector companies in Turkey.
- The Bank will take a balanced approach in high-risk countries such as Greece, Ukraine, Slovenia and Cyprus, where the Bank's activities will be carefully structured to have a meaningful economic impact, while avoiding deterioration of the portfolio risk profile. Apart from Greece, where it may be appropriate to engage in the process of reforming the financial sector, in volume terms the exposure to the financial sector in these countries will not grow significantly.
- The Bank will remain active in portfolio management in Russia and be ready to start developing new business. Overall the share of the Bank's portfolio in the Russian financial sector is expected to continue shrinking over the medium term.
- In the Central Europe, the Baltic and EU SEE countries the Bank's emphasis on the development of local capital markets with better integration into the global financial markets, GET lending and equity investing with a specific focus on non-bank financial institutions may result in fewer transactions, but of larger volumes. Overall, however, the share of this region in the Bank's financial sector portfolio would likely to marginally reduce over the medium term.
- In the Western Balkans and the CIS countries the Bank will concentrate on enhancing the quality and depth of the financial intermediation through SBI and SGI operations, GET lending and equity investments in support of market consolidation and improvement of business standards The evolution of the Bank's financial sector portfolio in these regions is expected to remain in line with the trend seen in the last years with the share of exposure remaining stable in the medium term.

As discussed in the section 7.2.7, policy dialogue is expected to be a key component of the Bank's activities in the financial sectors in most COO. Where possible, the Bank will continue to promote the coordinated approach, where policy dialogue and/or technical assistance is combined with financing as EBRD experience suggests that such an approach is more likely to have a stronger impact than each of the components delivered separately.

7.3. The Financial Sector Strategy: Performance Measurement

In line with the proposed strategic objectives the EBRD Financial Sector Strategy 2016-2020 will aim to achieve the following key outcomes across COO:

- Improved resilience and efficiency of banks
- Improved financial sector effectiveness and integration
- Improved breadth and depth of financial intermediation

Taking into consideration the high degree of uncertainty associated with the current economic climate and the demand-driven nature of the EBRD's financial sector business, it will be important to retain flexibility to respond to changes in the environment. At the same time, the strategic objectives are expected to remain valid throughout the new Strategy period.

The Bank's approach towards the measurement of the transition results was set out in the document "Country Strategy Results Framework: Design Implementation and Reporting".[11] The adopted approach puts the primary emphasis on measuring the results at the country level through the relevant Country Strategies. In line with this approach, the Financial Sector Strategy does not have a full results framework but a Performance Monitoring Framework (PMF) containing a set of performance measurement metrics that aim to provide an appropriate basis for assessing the Strategy performance and effectiveness at the end of its period.

Using the terminology adopted in the document "Country Strategy Results Framework: Design Implementation and Reporting" all proposed performance measurement metrics are measures of *outputs.* Such measures of outputs (which are direct measures of services provided through the Bank's activities) are appropriate for a sector Strategy as a more practical document which complements the Country Strategies in guiding operational activity in a sector, while the high-level specific objectives and results, often measured by *outcomes,* are achieved in a country context.

The analysis of output measures listed in the PMF, such as their trends and distribution across the priority themes and objectives, would serve as a basis for assessing performance and effectiveness of the Financial Sector Strategy 2016-2020.

[11] BDS14-217 (Final)

Performance Monitoring Framework

Strategic themes	Strategic objectives	Main activities	Performance Measurement
1. Supporting resilient and efficient banks	1. Development of a sound banking sector through improvement of business standards, restructuring and consolidation, and increased competition **(SO1)**	• Equity and debt financing for strong banks with attractive and sustainable business models • Restructuring and re- / pre-privatisation equity investments • Transactions that facilitate NPL resolution • TA and policy dialogue	• Number of bank equity investments (Baseline 2011- H1 2015 - 36) • Volume of debt financing for local banks (Baseline 2011- H1 2015 - EUR 6.5 billion) • Number of debt and equity transactions with objective to reduce NPLs in banks (Baseline 2011- H1 2015 - 6)
2. Improving financial sector effectiveness and integration	2. Strengthen the financial sector by achieving better diversification and integration into global financial markets **(SO2)**	• Equity and debt for non-bank FIs • Capital markets and structured finance • Local currency denominated lending • Trade finance • TA and policy dialogue • New products	• Number of equity investments in non-bank FIs (Baseline 2011- H1 2015 - 23) • Volume of debt financing for non-bank FIs (Baseline 2011- H1 2015 - EUR1 billion)[12] • Number of capital market transactions (Baseline 2011- H1 2015 - 38) • Volume of debt financing in local currency (Baseline 2011- H1 2015 - EUR 1.7 billion)
3. Enhancing financial intermediation	3. Foster financial intermediation in COO to reach under-served market segments and strengthen competition and market effectiveness in the financial sector **(SO3)**	• SBI/SGI lending • GET lending • Mortgage lending • Trade finance • TA and policy dialogue • New products	• Volume of SBI debt financing (Baseline 2011- H1 2015 - EUR 3.3 billion) • Volume of SGI debt financing (Baseline 2011- H1 2015 - EUR 0.3 billion) • Volume of GET debt financing (Baseline 2011- H1 2015 - EUR 2 billion) • Average annual turnover of the TFP operations (Baseline 2011- H1 2015 - EUR 1 billion)

[12] Excludes Deposit Insurance projects

7.4. Environmental and Social Compliance

In accordance with the EBRD's Environmental and Social Policy, financial institutions are required to comply with relevant Performance Requirements (PRs); PR2 (Labour and Working Conditions), PR4 (Occupational Health and Safety), and PR9 (Financial Intermediaries). Through implementation of the PRs the EBRD will continue to work closely with financial institutions in adopting environmental and social risk management and human resource management policies in line with good international practice in the financial sector.

A key objective of PR 9 requires financial institutions to develop and implement Environmental and Social Management Systems (ESMS) to manage the environmental and social (E&S) risks associated with their own operations and the business activities of their clients. The EBRD's approach is consistent with that of most other multilateral and bilateral development finance institutions.

In parallel, the EBRD places considerable emphasis on capacity building in order to assist financial institutions to understand and meet these standards and aims to support and strengthen the financial sector and investment to MSME and SME's. The Bank will continue to deliver its long-standing training programme for financial institutions through technical assistance as well as via the Bank's on-line E&S e-learning programme. These training programmes assist financial institutions in implementing environmental and social policies that meet EBRD's requirements and helps them operate in accordance with recognised good practice.

The EBRD will continue to monitor the environmental and social performance of the financial institutions. The EBRD Financial Institution Sustainability Index is designed to help financial institutions understand how they are responding to sustainability issues and the extent to which they have implemented a systematic approach to managing sustainability. The Index will allow financial institutions to periodically self-assess and, potentially, compare their progress in implementing effective sustainability risk management arrangements. The Index will also allow EBRD to compare financial institutions in this area over time in the implementation of the EBRD's Performance Requirements and to monitor progress at portfolio level.

Annex 1. Evaluation Department Analysis of the Financial Sector Strategy 2010

EvD Analysis of project evaluations against the objectives of the Financial Sector Strategy 2010

EvD seeks to engage constructively with Management in the preparation of sector strategy papers. The objective is to provide evaluation and results-related insights and suggestions sufficiently early in the process so that they may inform and ideally contribute positively to Management's thinking and final product.

This Annex provides a Summary of EvD's engagement in and substantive contributions to the FIBG's preparation of its new Financial Sector Strategy paper. After reviewing a draft concept paper that reflected substantial early FIBG thinking, EvD offered to bring together existing evaluation material which might help shape the strategic direction and delivery mechanisms for the strategy period, such as existing evaluations, lessons and sector level data, as well as its recent extensive work on results frameworks. EvD also offered to provide some reflections on the current strategy's fit and relevance. Given the already advanced stage of preparation of the Strategy, EvD did not initiate any new analysis or evaluation work for the purpose of the study but FIBG has welcomed EvD's engagement and suggestions.

This Annex looks at the Financial Sector Strategy 2010 (FSS 2010) to assess its relevance in the context of transition challenges (both in design and delivery), performance (based on existing evaluations of projects), and insights. Headline messages are:

- EvD considers relevance of the previous strategy is high, both in design and in implementation.
- FSS 2010 projects performed well with the vast majority rated highly successful or successful.
- 14 lessons identified in evaluations of FSS 2010 projects raise insights in project implementation delays, selection of clients, EBRD policy compliance and due diligence which can be useful as the team finalises and considers operationalisation of the new strategy.

Relevance of strategic aims: to bank's strategic direction as well as key sector transition challenges and individual country contexts

Based on a review of the EBRD's Country Strategies/updates, transition assessment documents and strategic initiatives at the time of the approval[13] of the FSS 2010, EvD considers relevance of the previous strategy is high, both in design and in implementation. The strategic document presented at board went further than the previous strategy[14] in learning from past experience,

[13] Some review also of subsequent changes or updates during the FSS 2010 strategic cycle, as appropriate

[14] Namely the 1999 Financial Sector Operations Policy

especially with regards to the crisis, taking into account the recommendations of the EvD's special study on the preceding strategy[15] (see table 1). The strategy took relevant analytical and strategic documents as its base,[16] including a detailed region specific assessment of transition challenges, which was aligned with the then-current transition report,[17] and also focused on strategic approach to collaboration between IFIs. In line with EvD recommendations, the strategy took a more systemic view of actions and impact on the development of the financial system as a whole; illustrated by the fact that it included non-bank financial institutions for the first time. However, it did not go so far as to include a clear results framework. The strategy focused on two overarching aims: fostering financial stability with real sector resumption (MSME). The five strategic priorities were identified as follows:

(i) Complete crisis response and stimulate lending to the real economy
(ii) Help develop local capital markets by both funding and lending in local currency
(iii) Promote better governance, sustainable business models and improved risk management of banks and non-bank institutions
(iv) Support consolidation, privatisation and re-privatisation of the banking sector
(v) Support development of new regulatory frameworks in close coordination with other IFIs, including in the area of cross-border regulation

The paper describes that achieving this was expected to necessitate a mixture of high quality investment operations, TC and policy dialogue, including on promoting corporate governance, responding to increasing demand for SEFF, help to develop the private equity market for financing, renewing the local currency market focus, and further the joint IFI action plan.

Table 1: Incorporating lessons from the EvD special study on the financial sector operations policy (2007)

Recommendation	Detail in 2007 study	Observation of 2010 strategy
Clearly focused policy priorities	Policy statements 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 as necessary	Section 4 reviews the remaining transition challenges in the region
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.	Such policy dialogue and TC support is described as operational priorities. The specific policy dialogue direction emphasised is developing the local currency market infrastructure in selected COO.

[15] PE06-338S (September 2007)

[16] In addition to the transition impact retrospective, Including the FIBG meeting the Crisis March 2009 paper, CRR4 documents and the ATC 2009

[17] Specifically, the transition impact retrospective which in 2009 (taking account of 2005-H12009), identified private equity (bond and equity market development) as critical

Future policy should re-emphasise the importance of market-supporting institutions and policies	The study observed focus on competition, market expansion and institution building which has contributed strongly to the ongoing transition process in those countries which 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.	Integrated as a priority in the strategy
Seek to integrate policy dialogue initiatives and market-supporting TC initiatives in the design of investment operations where possible	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.	Integrated as a priority in the strategy
Coordination with other IFIs	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.	Future directions for working with counterparties, with IFIs and with EU are described in some detail as key operational priorities.
The Bank should tailor interventions fully to initial country conditions when designing financial sector operations.	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.	Section 4 reviews the remaining transition challenges in the region
Funding technical cooperation initiatives	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 as well as make it more feasible to request beneficiaries to make a contribution to costs where appropriate.	This implication goes wider than FIBG and has been Implemented as a matter of ongoing business
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. 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.	This implication has been implemented as a matter of ongoing business

EvD also notes that the strategy provided sharper focus to the Bank's strategic priority on sustainable energy, linking financial sector operations to the SEI. Separately, EvD notes that the strategy did not explicitly take account of the gender priority of the EBRD which was an important strategic focus at, given the then-recent launch of its Gender Action plan in 2009.

The Country Strategy update of 2010 confirms that the outlined operational priorities were relevant responses to significant transition challenges across the bank's COO.[18] Further, a look at 7 selected Country Strategies further confirms the alignment and planned country specific contribution of FIBG to addressing some significant transition challenges.[19]

Table 2: Country Strategy alignment with the FSS 2010

Country Strategy[20]	**Crisis response and real lending support**	**Local capital markets and lending**	**Governance and sustainable business models**	**Consolidation and privatisation**
Russia 2009	√	√	√	
Turkey 2009	√		√	√
FYRoM 2010	√	√	√	
Albania 2009	√	√	√	
Belarus 2009	√		√	√
Armenia 2009	√	√		√

Effectiveness of the strategy: looking at delivery, project performance and transition outcomes

FIBG delivered investment and TA operations in many of the areas outlined above,[21] with emphasis on MSME support, SEI market development, local capital market development and corporate governance; there appears to have been much less activity explicitly targeting consolidation and privatisation through investment or TC, as outlined by table 3 below.

[18] Including MSMS support, corporate governance promotion, SEFFs, private equity market development and local currency market development

[19] Based on prominence to the portfolio volume/trend, additionality to regional coverage and chronological proximity of Country Strategy update to the FSS 2010: Turkey, Russia, Belarus, Armenia, Western Balkans (especially Kosovo, FYRoM and Albania)

[20] The Turkish and Russian Strategy updates of 2012 are also closely aligned to the FSS 2010.

[21] Taking Western Balkans as a whole

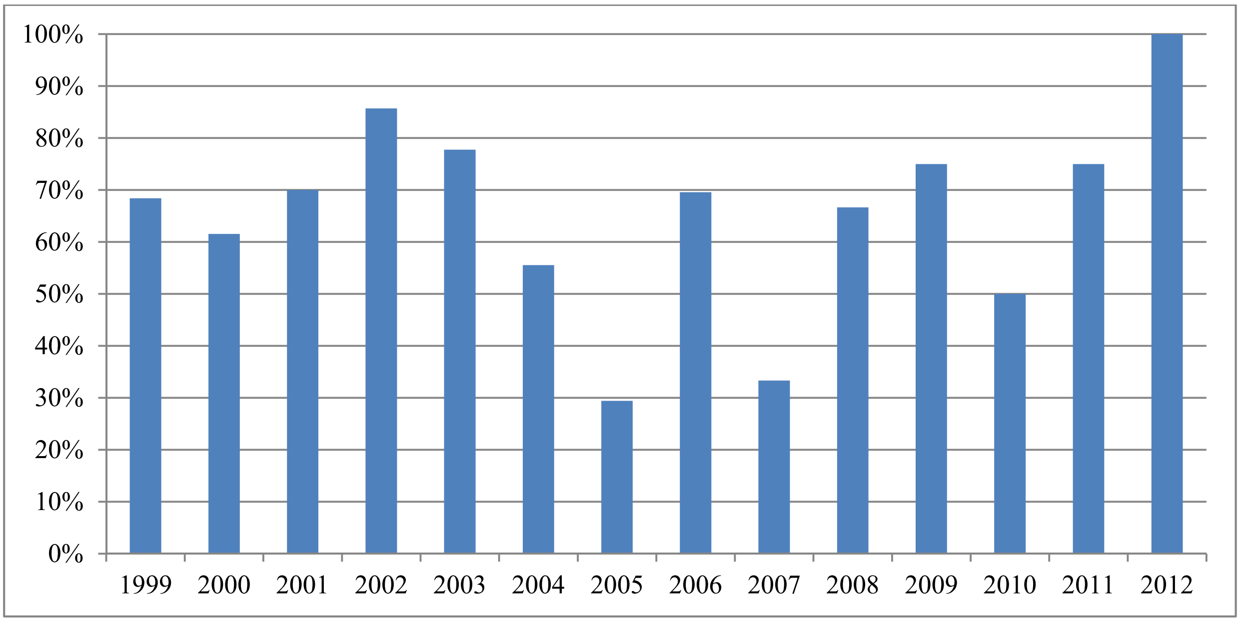
Table 3: Illustrative support for the delivery of the FSS 2010 priorities

Country	**Illustration of support approved for delivery by FIBG during strategic period 2010-2015**			
	Crisis response and real lending support	**Local capital markets and lending**	**Governance and sustainable business models *(some overlap with real lending programs)***	**Consolidation and privatisation**
Russia	• Russia Small Business Fund (inc TC) • MSME loans to banks (sometimes syndicated), and leasing companies • Equity investment in credit bank • SME guarantee framework • Some Bank specific TC for SME lending and credit risk management	• DPR securitisation programme investment • Development of selected normative documents for the Russian Credit Coop Sector • Training conducted on government securities markets	• RuSEFF and extension (with TC) • Assistance and training in loan workouts and corporate recovery for Russian Banks • Corporate Governance diagnosis of selected banks where the EBRD has an investment in place ad implementation of the action plan	
Turkey	• MSME support projects (especially in regions, with TC) • TurAFF (with TC) • TurEEF (with TC) • TurSEFF extension (with TC) • SME Asset backed bond • Turkey Trade Finance Banking forum (annual)	• Equity position in a Turkish insurance company • Buyer of TL denominated bond • TA to Central Bank in support of actions towards a domestic money market • Equity stake in a NPL company • Turkey Capital Market Framework	• MidSEFF I and II (with TC) • Turkey WiB (including TC)	
Western Balkans	• Western Balkans Women in business • KoSEP (and TC) • WebSEFF 2 (and TC) • WebPSSF (and TC) • SME loans and MSME credit advisory services • Trade finance advisory services	• Western Balkans and Croatia Financing Framework • Western Balkans Direct Financing Facility • Securities and Exchange commission TC (FYRoM)	• Deposit insurance fund support for Kosovo, Serbia and Montenegro • Central Bank support (Serbia)	
Belarus	• Belarus financial sector Framework II MSME loan		• BelSEFF (and TC)	
Armenia	• Various MSME credit lines/senior loans multibank financing framework extension		• CEEP (and TC)	

FIBG's business remains important for the delivery of the Bank's transition objectives. In 2015, FIBG's portfolio accounted for 29% planned EBRD ABI, while FIBG continued to diversify during this strategic cycle, across sector and countries. Between 2010 and 2015, Turkey grew in importance, Russia declined, and notably, SEMED saw a considerable increase in the business volume and currently accounts for 5% FIBG portfolio[22].

FIBG projects have performed well over the strategic cycle, as figure 1 shows. EvD has evaluated 168 FIBG projects since 1999, excluding self-evaluations whose ratings were not validated. Of these, 103 were highly successful or successful, and only 14 were found to be unsuccessful. EvD has evaluated 9 projects approved under the 2010 strategy in depth – it found none to be unsuccessful, with 6 being either highly successful or successful. Interestingly, there was no difference between EvD and banking team overall ratings.

Figure 1: The proportion of highly successful or successful FIBG project performance over time as a percentage of those evaluated

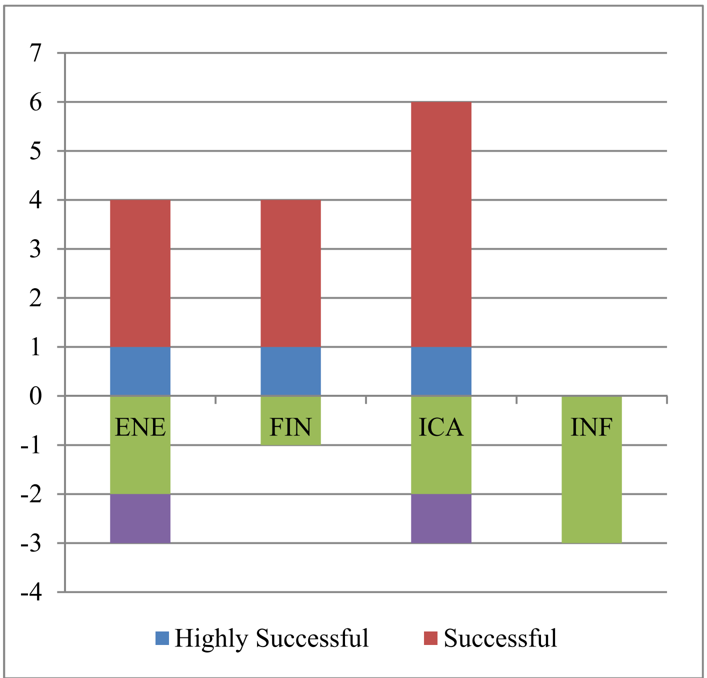


In addition, as figure 2 illustrates, when compared to other sectors,[23] FIBG projects are doing well.

[22] Data from Business Performance Navigator

[23] The strong caveat is that the sample is very small, and the sector projects different in nature and expected delivery timelines such that it is difficult to usefully compare them over such a small timeframe.

Figure 2: Project ratings as evaluated by EvD, by sector, for projects approved during FSS2010 cycle



Looking at the latest transition report (2014), FIBG activities over the last strategic cycle are in line with some progress in closing certain sector transition gaps, though there is much remaining to continue to focus on. The report notes that improved access to finance for SMEs has triggered a number of upgrades. Turkey, Albania, Kosovo, and Montenegro are all such examples, which is notable given the ongoing MSME support work of the Bank in the financial sector. Private equity broadly persists as a transition gap across all regions. Importantly, the report indicates that regionally, no large gaps remain in Central Europe and the Baltic states. Table 4 gives an overview of the large transition challenges in the financial sector by region.

Table 4 Transition gaps in the financial sector

Transition source	Sector	Number of countries with large gaps	Details
Structure of markets	Banking	9	CEE and CA
	Insurance	13	all regions but CE and Baltics, also only Egypt in SEMED
	MSME Finance	12	CEE, CA and SEMED
	Private Equity	17	all in C Asia, only Egypt I SEMED
	Capital Markets	19	Morocco in SEMED, all CA and CEE
Market Supporting Institutions	Banking	7	
	Insurance	8	Kosovo in SEE only, none in SEMED)
	MSME Finance	14	(Russia, Kosovo, all CA and All SEMED)
	Private Equity	15	only Tunisia in SEMED
	Capital Markets	13	only Jordan in SEMED.

As a note on gender, the transition report specifically looks at gender gaps in COO. The report indicates that the inclusion gap for gender in terms of access to finance is a significant issue for future consideration. Large transition gaps persist in all regions except for Central Europe and the Baltic states: in total this is 11 countries, including Turkey, Albania, Cyprus Kosovo, and all countries in the SEMED region.

Lessons from project level evaluations:

Lessons[24] identified in evaluations of projects which were approved and implemented during the 2010 strategy period discuss issues of project implementation delays, selection of clients, EBRD policy compliance and due diligence recommendations. Table 5 outlines the headline messages. The database of lessons is rich, containing information on investments, as well as on TC [25] and policy dialogue[26] interventions as well as IFI coordination,[27] which cover the operational priorities of the 2010 strategy and several areas of the new Financial Sector Strategy 2015.[28]

Table 5: Lessons identified from evaluated projects under the FSS 2010

Project Design Theme
Enhancing competition through diversifying strategic owners: Whilst there is a risk that sponsors that are new to a market may take longer to adjust to local market conditions, if they can partner with a strong local management, there is an opportunity to strengthen the market by introducing an alternative approach. The Bank should look to identify opportunities where it can support the entry of strategic investors from other regions to achieve this. (OpID 41793)
Selecting an appropriate client bank for funding of SME loans: Choosing a client bank which prioritises community banking as its core business to finance small scale enterprises, in line with the EBRD country strategy of providing long term capital to the SME sector is important. The choice of the partner bank to be financed by EBRD has been proved to be appropriate also because of the bank's experience and knowledge of the local community and its substantial presence in underdeveloped regions through the branch network. (OpID 43025)
Ensuring breadth of investor base to minimise risks of low demand: Transactions should be structured to accommodate the needs of foreign investors to tap a wider investor base. This would necessitate English law agreements, resolution of tax issues and accommodation of other jurisdictions. (OpID 43129)
Capturing strong interest from participating client banks: Targets for reaching the operating participating client bank level in future Apex led situations could be more ambitious. (OpID 41701)
Business focus in crisis environment: It is important to be flexible and able to navigate the strategy depending on the market developments. While change of business focus may hamper full achievement of certain TI benchmarks, timely decision may be critical for the business sustainability in adverse environment and may eventually be the key driver for maximising probability of achievement of bigger targets. In REB's case, timely change of focus allowed it to maintain strong and better than the market average performance, hence preserving the bank's value and attractiveness for potential sale in the future. (OpID 41882)

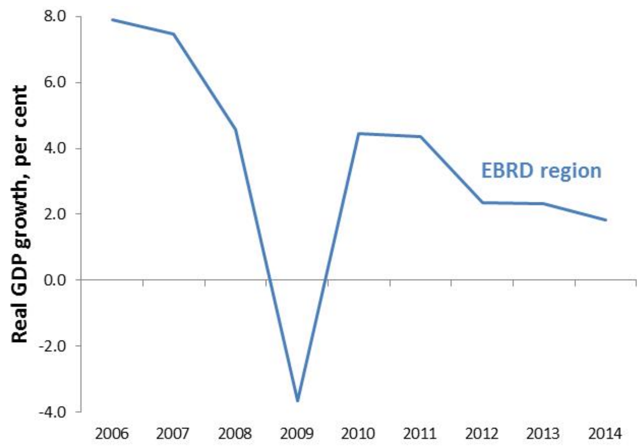
[24] 14 in total lessons are included in the lessons investigation application
[25] 28 lessons
[26] 14 lessons
[27] 6 lessons
[28] As a note, lessons there were no lessons in the following areas:private equity support, virtual banking, deposit insurance, gender aspects and agricultural MSME support

Financial projections need thorough testing: It is important to test projections to a higher degree on the more conservative side. (OpID 42385)
Exit depends on external factors such as market liquidity: While equity investment certainly assumes full market risk, where possible and practicable, the EBRD should seek to enhance its exit opportunities through put options or other structured solutions.(OpID 41882)
Project Implementation Theme
Delays caused by unlimited flexibility in allocating funds to a single parent /intermediary for onlending: When lending to a financial intermediary with a number of subsidiaries, the Bank should provide a list of preferred subsidiaries and take an active role in allocation to prevent abuse of parents' competence to distribute the funds. (OpID 40817)
Delay in disbursement of funds and distribution to PCBs stemming from associated TC: When lending to a financial intermediary with a number of subsidiaries, the Bank should provide a list of preferred subsidiaries and take an active role in allocation to prevent abuse of parents' competence to distribute the funds. (OpID 40817)
Making sure transition impact and environmental and social requirements are fulfilled: The sections of project agreements which aim to address the Bank's specific areas of concern (environmental and social requirements, provisions related to events of default and intended use of proceeds) should include regular reporting requirements and must make clear the legal consequences of breaches of such reporting requirements. Standard requirements in regard with the structure of the asset guaranteed bond and the asset pool, and the local legislation which provides the grounds of such bond transactions are stipulated in the subscription agreement and accompanying documents. (OpID 43025)
Importance of successful precedent transactions: Understanding the local investor appetite for new structures and increased marketing/targeting efforts (such as roadshows) could insure better book building for future locally placed transactions. The performance of this transaction itself is also expected to set a strong precedent for future transactions in Poland. (OpID 43129)
Delays and difficulties in delivering an IT workflow tool to participating client banks: Project objectives of developing tailored IT systems to assist MSME lending processes need to be well thought through and carefully planned, ensuring allocation of adequate resources and time. Projects such as these are large-scale, costly and would be entirely funded and managed by the client bank. (OpID 41701)
Maintaining relationships even in difficult circumstances: To retain a good relationship, EBRD should look to maintain its willingness to propose and consider new transactions as well as keep an open mind on structure and collateralisation issues that might otherwise provide a disincentive to more successful clients from dealing with us. (OpID 42444)
Alignment of shareholders interest is highly important: It is important that the EBRD seeks to establish exit terms as a legally binding obligation by the parties. This is a strong motivation for the counterparties to keep looking into various options even in the negative environment (for example with the client continuing to initiate discussions with various players and seriously looks at M&A opportunities), while otherwise the key owners may see no reason to move on. (OpID 41882)

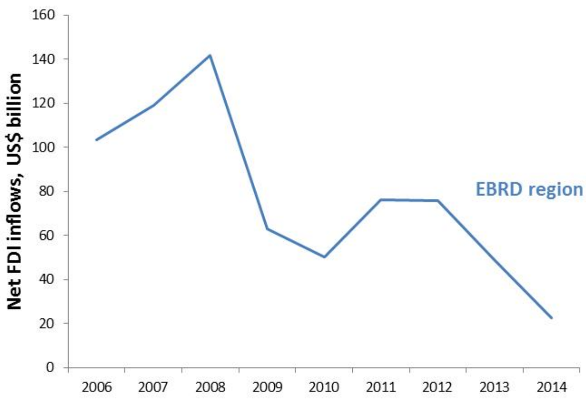
Annex 2. The economic environment in the region and its impact on the financial sector

This annex analyses the macroeconomic environment in COO, its main drivers and impact on the financial sector. It partially draws on EBRD's Transition Report 2015-16: Rebalancing Finance.

EBRD COOs have experienced a period of volatile and stagnating economic growth during 2007-11 (*the chart to the right shows the GDP growth rate in the EBRD region between 2006 and 2014*[29]).



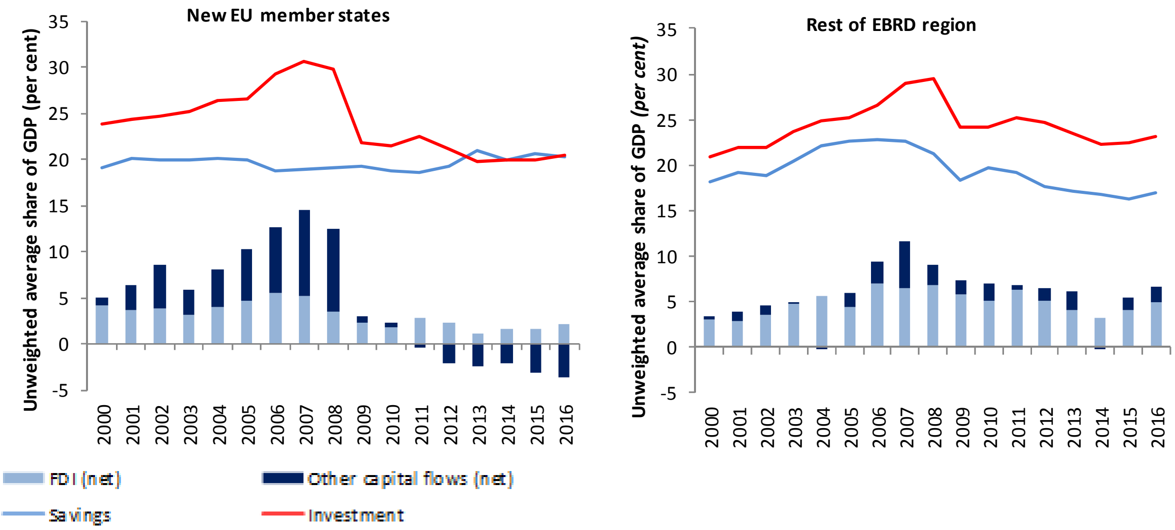
The reduction of cross-border capital flows into the COO was a significant driver of this trend. Cross-border capital flows played a key role in supporting growth in emerging Europe during the 2000s. To a large extent, those strong capital inflows came in the form of FDI and were accompanied by deeper institutional integration with more advanced European economies in the context of the EU accession of countries in central and south-eastern Europe.[30] Inflows of FDI, as well as other capital inflows, enabled Europe's emerging markets to sustain relatively high levels of investment given their traditionally low levels of domestic savings. In turn, these high investment levels supported growth. Most capital inflows in the region came from countries in the Eurozone, such as Austria, Germany and Italy. Increased foreign ownership of banks played a very important role, both as a form of FDI in the financial services sector and as a channel for the financing of investment.



Following the 2008-09 crisis, FDI from advanced European economies to emerging Europe and Central Asia fell sharply as Europe battled its economic crisis and the Eurozone experienced a protracted recession (*the chart on the left shows the dynamics of FDI in the EBRD region between 2006 and 2014*[31]).

The reduction of FDI, combined with the impaired ability of local financial institutions to lend, was one of the main drivers behind the significant decline of investment in EBRD COO since 2008 (*the following two charts emphasise the relationship between, on the one hand, the reduction of FDI and other cross-border inflows and, on the other hand, investment in EBRD COO*).

[29] IMF World Economic Outlook
[30] See Friedrich et al. (2013).



As investment fell so did the creation of new jobs in the region. The rise of unemployment increased social pressures and further strained public finances, exacerbating the negative effects of the economic contraction in the region.

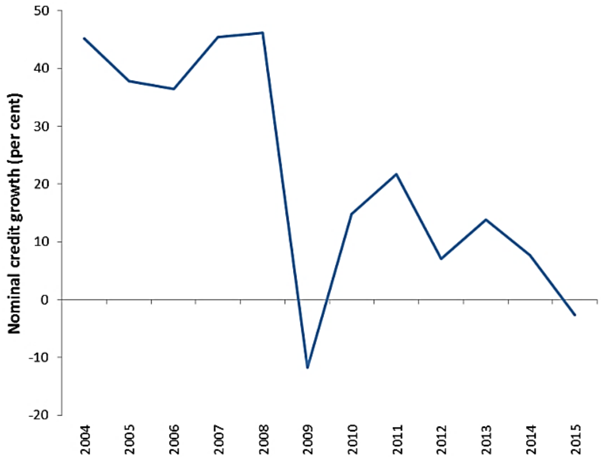
While the present economic environment varies from country to country, overall it remains challenging. To illustrate this, the Bank has mapped the three-year trend (2012-2014) of GDP, FDI, Private Credit and Unemployment[31] for all COO (*see the table to the right*) and has found that of the 36 COO:

- 22 showed contracting GDP
- 26 displayed a negative trend along at least two of the four macroeconomic indicators;
- Only 4 countries (Jordan, Morocco, Poland and FYROM) did not show any negative trends; and
- Only 2 countries (Poland and FYROM) had all four indicators showing consistently positive dynamics.

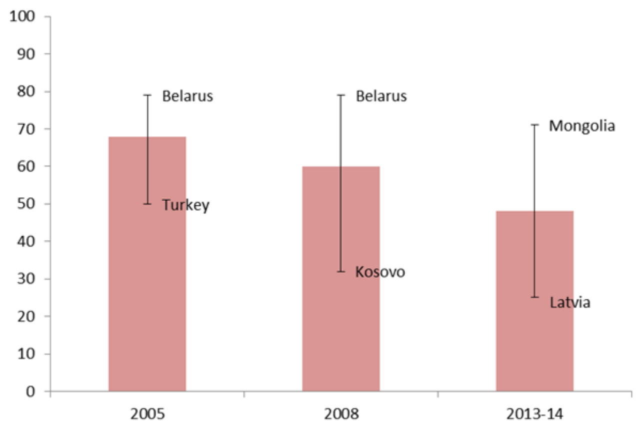
	GDP	FDI	Private Credit	Unemploy-ment
Albania				
Armenia				
Azerbaijan				
Belarus				N/A
Bosnia & Herzegovina				
Bulgaria				
Croatia				
Cyprus				
Egypt				
Estonia				
FYR Macedonia				
Georgia				
Greece				
Hungary				
Jordan				
Kazakhstan				
Kosovo				
Kyrgyz Republic				
Latvia				
Lithuania				
Moldova				
Mongolia				
Montenegro				
Morocco				
Poland				
Romania				
Russia				
Serbia				
Slovak Republic				
Slovenia				
Tajikistan				N/A
Tunisia				
Turkey				
Turkmenistan				N/A
Ukraine				
Uzbekistan				

31 Sources: IMF and the Economist Intelligence Unit. For "Unemployment" the reduction signifies a positive trend

Private credit is a particularly important measure in the context of the financial sector activity. For EBRD COO it shows a significant contraction since 2011 (*see the chart to the right*), suggesting that the effectiveness of the financial sector has been impaired. This trend has been a focal point of the regional central banks and actively debated in the academic literature and professional media with the debate specifically focusing on whether the supply of or the demand for credit was the main factor behind the contraction.

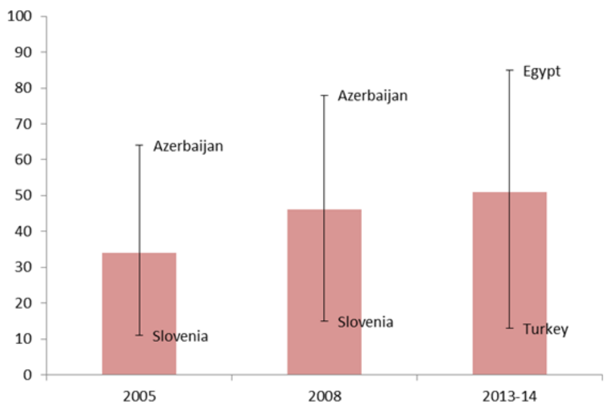


As a practitioner in the sector the Bank gathers its evidence and insights from engagements with clients, regulators and other governing bodies in the context of its financing operations or policy dialogue activities. It has observed that in most COO both the *supply* of and the *demand* for financing have been affected.



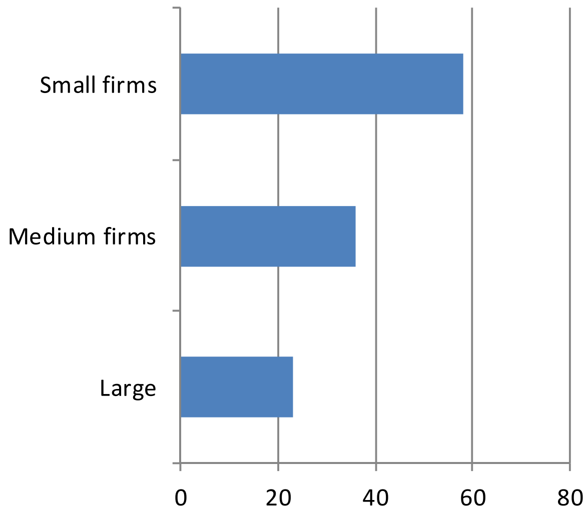
These observations have been confirmed by the Business Environment and Enterprise Performance Survey (BEEPS) conducted by EBRD and the World Bank in 2005 (BEEPS III), 2008-2009 (BEEPS IV) and 2013-2014 (BEEPS V). The survey of a large sample of small- and medium-sized enterprises showed a significant decline of the *demand* for new financing (*see chart on the left*), especially for financing of capital expenditure (i.e. investment) since 2005. The variation of responses from country to country has also widened, consistent with the significantly varied financial sector performance in different countries in the aftermath of the financial crisis.

At the same time BEEPS have also found that the share of companies that were credit constrained[32] has increased and so did the variation of credit-constrained companies from country to country (*see the chart to the right*), which indicates the reduction of *supply* of new loans.

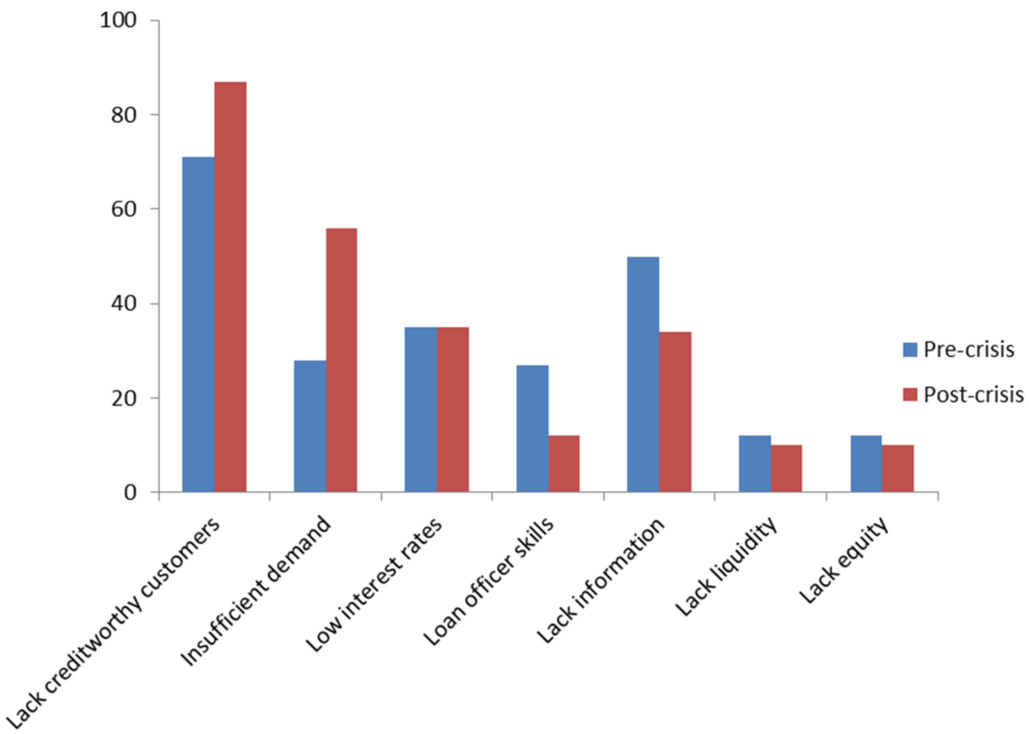


[32] Firms that need additional credit but are either rejected when they apply for a bank loan or feel discouraged from applying for such a loan

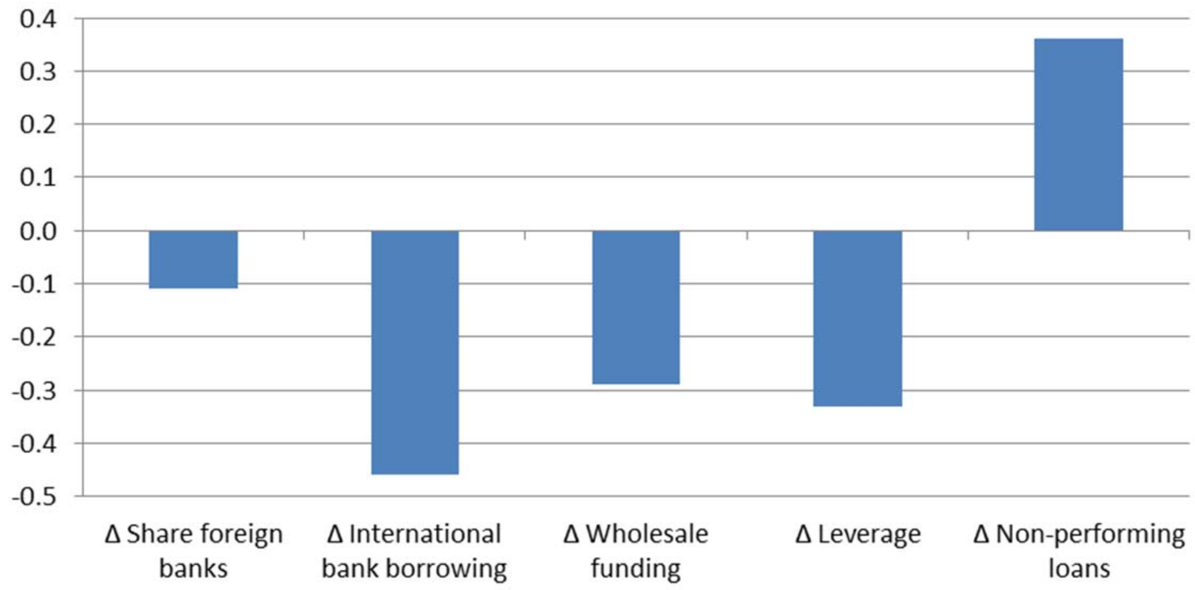
The chart on the left provides further insight into which types of firms are most credit constrained. The chart shows the proportion of the credit-constrained companies by size, suggesting a much larger problem in the segment of small companies.



This insight is consistent with the Bank's own observations. One of such observations was that the reduction of new lending to the SME customer segment was associated with the increased "discomfort" of banks in the region to lend. The reasons behind such "discomfort" were both external (deterioration of the operating environment and customer risk profile) and internal (reduction of risk appetite, prompted by the tightened capital adequacy requirements). Therefore, while the chart below shows that the majority of banks surveyed by BEEPS quoted the "lack of creditworthy customers" as a key factor that contributed to the reduction of the new lending, in reality the reduction was equally influenced by a shift in the banks' risk appetite as the test for "creditworthiness" has become much more stringent after the crisis.

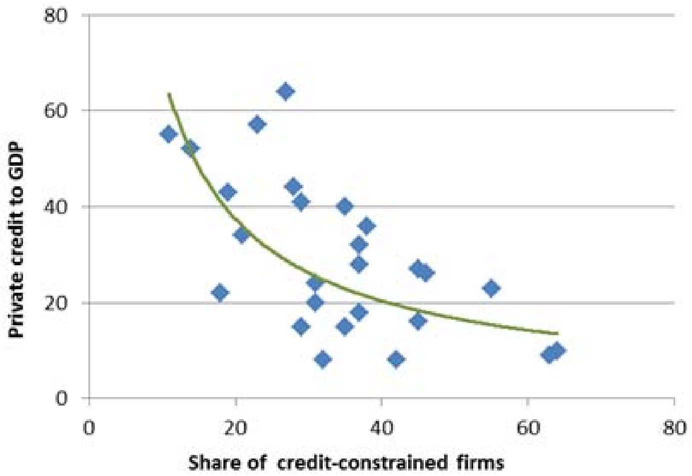


The ability of banks to continue lending to the real economy was affected by many factors other than the tightened regulation. The chart below shows the evolution of some of such factors since 2005. For example, the reduction of cross-border borrowing and wholesale funding shortened the duration of bank liabilities and restricted the ability of banks to lend long-term (i.e. affected the *supply* of term funding to the real economy). The increase of NPLs, in combination with the tightened capital adequacy regulations, further constrained the ability of banks to lend, particularly to the segments that were perceived as high-risk and attracted a higher capital charge.



Finally, structural problems in the sector (such as market fragmentation, underdevelopment of local currency and capital markets, dominating role of the state-owned institutions, inadequate legal infrastructure, etc) played a key role in the financial sector turbulence and in many ways were the root of the problem.

The chart to the right supports this assertion. It uses private credit as a proxy of the financial sector effectiveness and measures the private credit penetration against the share of credit constrained companies in various EBRD COO. It shows that more effective and more competitive financial sectors in general have fewer credit constrained companies.



Consequently, the proposed strategic objectives under this Financial Sector Strategy focus not only on addressing specific problems that have hampered financial sector development but also on facilitating important structural changes to improve the overall effectiveness and competitiveness of financial sector in the region.

Annex 3. Selection of the Partner Financial Institutions (PFIs)

The selection of new PFIs will continue to be guided by the following fundamental criteria:

- The financial standing of the PFI

  The Bank will be primarily guided by its "sound banking" principle. In the banking sector the bias will be towards the banks with sizeable market share, sound financial standing and strong business models, tested by the recent crisis. For non-bank PFIs the size and market relevance will matter less, but the financial performance and robustness of the business model will be of critical importance.

  While the Bank intends to support a diversity of business models the recent market developments require a more thorough scrutiny of potential and existing bank clients, their business models and sustainability of their competitive advantages.

- The PFI "relevance" in the context of EBRD mandate

  The Bank will prioritise the PFIs that could play a role of "transition delivery agent" able, in a meaningful way, to facilitate progress on one or several dimensions of the Bank's transition agenda in the region. Examples of such "relevant" PFIs would include banks of systemic importance or with significant market shares, non-bank financial institutions that play an important niche role (such as leasing and factoring companies) or a role that is essential for the stability and effective operation of the financial markets (such as central clearing platforms, exchanges and deposit insurance agencies), banks and non-bank financial institutions that through their characteristics or market activities spearhead the market evolution (such as "challenger" banks and non-banks, innovative PFIs, fast-growing PFIs with unique customer value proposition).

- The PFI reputation, integrity profile and ownership

  Through all of its interventions in the financial sector the Bank will continue paying particular attention to the reputation and integrity of PFIs, emphasising transparent and efficient governance, shareholding structure and information disclosure.

In selecting its new PFIs the Bank will not compromise on the criterion of reputation and integrity. Similarly, the PFI's relevance in the context of the transition mandate should be observed in all cases. In rare cases, and only where the PFI relevance in the context of the EBRD mandate is particularly strong, the Bank may engage with PFIs that (at the time of making the operational decision to engage) may not display as strong a financial standing as generally seen. Examples of such operations could include: a restructuring or a turnaround investment in a failed, but systemically important bank; investment in a start-up or an early-stage PFI with a unique and high-potential customer value proposition; participation in a bond issue of a small or medium-sized local bank; financing for a small or medium-sized bank that aims to substantially expand its activity in a field that is highly relevant for the Bank's mandate (e.g. GET, SBI, SGI, LC2), especially in the context of a financial sector with a strong presence of state-owned financial institutions.

The Bank will prioritise engagement with privately-owned PFIs. However, there can be a case for a more nuanced approach to engaging with a state-owned or state-controlled PFI, particularly in situations where the private financial institutions do not have sufficient capabilities to be EBRD partners in the context of a specific product and where the size and market share of a PFI is a key factor in a successful product delivery. The examples of such situations may include: a state-owned bank with a wide regional presence that is ready to be EBRD partner in developing MSME and GET financing, while the private players do not have sufficient regional presence for the EBRD financing to have a meaningful impact in the country; or a state-owned bank with a strong credit risk rating that has expertise in capital markets and is willing to be EBRD partner in advancing the local currency funding and local capital market development in a country, whereas none of the private players have sufficient expertise or credit standing to provide similar support to EBRD in the market (for example, the recently approved EBRD investment in a senior bond issued by the National Bank of Egypt).

When engaging with a state-owned or state-controlled financial institution the Bank will have to satisfy itself that the potential partner bank operates on commercial basis, does not use its state-ownership to compete unfairly, is subject to the same regulations as the private operators in the same market, has a degree of managerial autonomy and appropriate corporate governance standards.