DOCUMENT OF THE EUROPEAN BANK
FOR RECONSTRUCTION AND DEVELOPMENT

FINANCIAL SECTOR STRATEGY

Dealing with the Legacy of the Crisis and Supporting the Development of Sustainable Financing of the Real Economy in EBRD Countries of Operations

As approved by the Board of Directors at its meeting on 12 October 2010

TABLE OF CONTENTS

ABBREVIATIONS

ABF	Asian Bond Funds Initiative
ABMI	Asian Bond Markets Initiative
ATC	Assessment of Transition Challenges
CEB	Central Europe and Baltic States
CEO	Chief Executive Officer
CIS	Commonwealth of Independent States
COO	Countries of Operation
EBRD, the Bank	European Bank for Reconstruction and Development
EC	European Commission
EEC	Eastern Europe and Caucasus
EMEAP	East Asia Pacific Central Banks
ETCs	Early Transition Countries
EU	European Union
GBP	Pound Sterling
IBP	Institution Building Plan
IFC	International Finance Corporation
MSME	Micro and Small and Medium Enterprises
NPLs	Non-Performing Loans
RSBF	Russian Small Business Fund
SAB	Sibacadembank
SEE	South Eastern Europe
TC	Technical Cooperation
TCX	The Currency Exchange Fund
TFP	Trade Facilitation Programme
TIR	Transition Impact Retrospective
UVTB	Uralvneshtorgbank
URSA	URSA Bank

EXECUTIVE SUMMARY

This recommendation and the attached Financial Sector Strategy are submitted to the Board of Directors for consideration and approval.

Previous financial sector policies were approved by the Board in 1992 (BDS92-030), 1996 (BDS96-092) and 1999 (BDS99-063), and the report briefly reviews their implementation.

Since the adoption of the last Financial Sector Policy in 1999, the financial sectors of EBRD's countries of operation (COO) have undergone dramatic changes. The first half of the decade since 1999 saw a gradual and sustained development of financial sectors in most countries, although with significant variations in emerging structures and speed of change, reflecting different initial conditions as well as the pace and quality of reforms.

The second part of the decade saw rapid acceleration in credit growth, fuelled by foreign financing in the context of benign global financial conditions. Foreign capital has helped stimulate growth and convergence but has also left certain vulnerabilities in many countries. Ready availability of foreign capital led, in some cases, to excessive credit growth and reduced the urgency of developing domestic capital markets and of establishing the conditions that would encourage the development of long-term savings instruments. Some of these vulnerabilities were amplified as the global crisis hit the region in the autumn of 2008.

The Bank's initial crisis response focused primarily on the banking sector. Significant resources were deployed through initiatives that employed EBRD's experience and credibility in the region to bring clients, other IFIs and home-host authorities together to address the issues in a cooperative and informed manner, such as through the Joint IFI Action Plan and the Vienna Initiative. These efforts played a timely role in averting a systemic banking sector and currency collapse in the region.

The Financial Sector Strategy builds on lessons learnt from the period leading up to, as well as during the crisis, along with the identified transition challenges. The key lessons for the Bank include:

- Rapid credit growth and heavy reliance on foreign borrowing can generate structural vulnerabilities that lead to systemic instability in a crisis.
- The Bank's approach to financial system development needs to focus on the broader needs of the financial system, such as adjusting to the new, evolving legislative/regulatory frameworks in the wake of the crisis and improving basic financial infrastructure, while recognising that the Bank's primary competitive advantage is the delivery of high quality projects.
- While there has been substantial progress in developing sound financial intermediaries in the region, the institutional transition is far from complete, with risk management and corporate governance among the areas that require renewed attention.

- Addressing the needs of the sector in the region will require a cooperative approach, which will have to include the private sector, national authorities and the IFIs.

Accordingly, the key twin objectives of the Financial Sector Strategy are to deal with the legacy of the crisis and support the development of more sustainable financing of the real economy.

The Bank will therefore pursue five strategic priorities:

- Complete the crisis response activities and stimulate lending to the real economy.
    - Promote and participate in balance sheet re-structuring and re-capitalisation of banks.
    - Provide additional capital for banks which are likely to be successful providers of financial services in the medium term.
    - Support the resumption of trade in the region through an active Trade Facilitation Programme.
    - Provide long-term funding for on-lending, particularly to targeted priority activities, such as MSMEs and Energy Efficiency.
    - Explore alternatives for supporting MSMEs beyond regular credit lines.

- Help develop local capital markets and both funding and lending in local currency.
    - The Bank has embarked on a major project to support local capital market development and enhancing local currency funding and lending.
    - An important element will be the development of the conditions and financial infrastructure that make local capital markets viable and local currency debt attractive for both lenders and borrowers. This would include increased attention to financial institutions that are more focused on longer term financial instruments, such as insurance companies and pension funds.
    - The conditions differ from country to country and different approaches and timescales will be required to achieve the Bank's long-term goals. Flexibility and creativity will be necessary to make meaningful progress.

- Promote better governance, sustainable business models and improved risk management of banks and non-bank institutions.
    - The Bank will work with its clients to identify risk management and corporate governance shortcomings and address them through proactive engagement. Sound projects, accompanied by TC and policy dialogue, will be key to meeting these objectives.

- Support consolidation, privatisation and re-privatisation of the banking sector.
    - Work with national authorities to re-privatise banks which were nationalised as a consequence of the crisis.

  - Through its interaction with the regulators and relationships with banks in the region, promote consolidation where appropriate.

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

The Bank will continue to be primarily focused on delivering high quality projects that meet the key criteria of sound banking, additionality and transition impact, but will also take a broader perspective and seek to influence the development of financial markets and contribute to financial stability.

A healthy, efficient and stable financial sector remains the cornerstone of a market economy. I believe that the proposed Strategy will help address the needs of our region's economies and their financial sector in the years to come.

1 DOCUMENT STRUCTURE

This document is structured as follows:

- Section 2 reviews financial sector developments in the region since the Financial Sector Policy was approved in 1999.
- Section 3 describes how the Bank implemented the previous policy, how the financial sector portfolio evolved and how the Bank responded to the recent crisis.
- Section 4 reviews the remaining transition challenges in the region.
- Section 5 outlines some of the lessons learned during the crisis and notes some of the implications for the Bank's approach. The key findings of the Evaluation Department's comprehensive report on the 1999 Policy are noted in Annex 2.
- Section 6 discusses in some detail the Bank's strategic objectives and operational priorities for the financial sector. It also outlines some of the implementation issues, including noting the parties with whom the Bank will work, cooperation with other supranational bodies and priorities for policy dialogue and technical cooperation.
- Section 7 discusses the Bank's experience with equity funds and outlines the operational priorities for this activity.

Annex 1 provides EBRD's assessment of the transition challenges for the countries in the region. Annex 2 presents a summary of the results of the Evaluation Department's 2007 Special Study on the 1999 Financial Sector Operations Policy that had been completed before the crisis. Annex 3 describes the steps that were taken in East Asia to develop local currency bond markets after the Asian Crisis.

2 FINANCIAL SECTOR DEVELOPMENT SINCE 1999

2.1 The overall setting: financial sector developments over the past decade

At the time of the adoption of the previous *Financial Sector Operations Policy* in 1999, financial sectors in most of the Bank's COO were recovering from the aftermath of the Russian financial crisis. Up to the Russian crisis, financial sectors had developed relatively rapidly - albeit from very low levels - addressing basic issues in the sector: establishing a two-tier banking system; privatisation; starting to build key institutions; basic financial intermediation; increasing competition; and liberalising prices. Financial intermediation was still very low by any measure even in the most advanced transition countries; lending and savings instruments rudimentary; and the non-banking sector virtually nonexistent. The period was marked by recurrent banking sector crises which had to be addressed with repeated government intervention; the last one was the Russian crisis in 1998. Its impact on the banking sector was significant, particularly in the CIS, but it was localised and contained, and, as with the other smaller crises, helped cleanse the banking sector and move ahead with reforms.

Since 1999 the financial sectors has undergone massive and dramatic changes in most COO, under three distinct periods:

A. 1999 to 2005: recovery from the Russian crisis and sustained development of the sector

- With a few exceptions, privatisations of state-owned banks were completed.
- Competition increased.
- Many countries opened up their capital accounts as well; for EU candidates this was as part of the *acquis communautaire*, but others also took this step.
- Financial integration proceeded to levels almost unparalleled in economic history. A few EU-based bank groups proceeded to acquire majority stakes in dominant banks in CEB and SEE countries and increased their presence in the EEC countries (in particular, in Ukraine). Financial integration also started to develop within the CIS between Russia and Kazakhstan on the one hand and smaller CIS countries on the other.
- A financial deepening took place, with credit/GDP ratios rapidly rising, albeit from very low/suppressed levels. Credit constraints in more remote countries and regions became less prevalent.
- The scope of financial products widened, including to micro and small and medium enterprises (MSME) and to mortgage borrowers in the CIS. Non-banking (insurance, private pensions, bond markets), started to develop in earnest, although local capital markets remained underdeveloped with the exception of a few countries (Russia).
- Evolution of sub-sectors:
  - Banking: deepening (credit-to-GDP ratios), growing share of foreign banks in total assets, declining share of state owned banks in total assets, greater access to finance (including mortgage lending to households, expansion of MSME lending).
  - Non-banking: growth of insurance and leasing.
  - Capital markets/private equity: increased stock market turnover, cross-border listings, more private equity activity.
- Progress was also made in developing market-supporting institutions:
  - The legal-regulatory framework of EU members and candidates was made akin to EU requirements.
  - Regulatory frameworks of many other countries – including in Armenia, Georgia, and Serbia – improved with regards to ownership and capitalisation, and prudential supervision was strengthened. Several countries also made progress in the regulation of leasing and insurance sectors, and the specific concerns of the MSME sector were given greater prominence.
- No major financial sector stress emerged.

B. Build up of financial sector vulnerabilities from 2005 - onset of the global financial crisis 2007/2008

- Very benign global financial conditions with excessively high risk appetite led to large capital inflows and fuelled credit booms, often leading to asset price bubbles in the region.
- Subsidiaries of European banking groups with access to ample funding from parent banks were eager to expand their market shares across the transition region. In addition, many domestically owned banks tapped international bond and syndicated markets (in particular, in Russia, Ukraine and Kazakhstan).
- In this period, foreign exchange lending to un-hedged retail borrowers took off in many countries (Baltics, Hungary, Ukraine).
- Rapid credit growth and financial intermediation were problematic for three main reasons:
    - ➢ Foreign financing, particularly wholesale (often short term) and portfolio finance, was prone to reversal in a crisis.
    - ➢ In many countries, a large share of domestic lending was denominated in foreign currencies, including to un-hedged households and enterprises. This limited the role of the exchange rate as a crisis management tool.
    - ➢ Credit in many countries was channelled to real estate and construction sectors, leading to rapid appreciation of house and land prices, which were, in retrospect, unsustainable.
- Regulatory and supervisory frameworks in many countries struggled to contain credit growth without major success. There was no home-host supervisory coordination to limit vulnerabilities. Regulatory frameworks proved pro-cyclical (similarly to those in advanced countries).

C. Crisis and crisis response (2008-10)

Capital inflows into the region initially continued in a general decoupling of emerging market finance in the first year of the crisis with developments in the advanced world (with the exception of Kazakhstan), but the financial crisis hit the region in the fourth quarter of 2008, following the collapse of Lehman Brothers. Emerging market risk premiums shot up, new loan syndications dropped sharply and cross-border net lending turned negative.

Nevertheless, cross-border lending flows to the region (excepting Russia and Ukraine) contracted less sharply than to other emerging market regions. The outflows were mild thanks to the predominance of strong foreign ownership with firmly committed parents in local financial systems and to a timely and large international policy response.

As foreign capital inflows receded, domestic confidence in financial systems was at times shaken. In some countries—including the Baltics, Ukraine and Russia—large deposit withdrawals tested the resilience of the financial system. In some cases, governments had to provide liquidity support and capital injections to mid-sized and large banks. Governments have acquired significant shares in banks in Kazakhstan, as well as Ukraine and Russia.

High credit growth in evidence in most countries until September 2008 slowed down quickly in the wake of demand contraction and freezing of some of the financial markets. Credit started to contract in most countries by the second quarter of 2009, leading to an effective credit crunch.

As the crisis spread across the region, governments provided significant volumes of liquidity to their financial sectors to prevent systemic collapses. A number of countries tapped IMF and EU resources that were made available to them at levels unseen in previous crises. However, the impact of the crisis on the financial sectors varied across the region.

A significant element of crisis response has been comprehensive IFI support to the private financial sector. Under the Joint IFI Initiative, the EBRD, the EIB and the World Bank pledged to provide up to €25 billion of financing over two years to financial institutions operating in the transition region.

The broader Vienna Initiative has established a consensus on responsibilities and burden sharing during the crisis with:

- Host governments providing assurances of deposit insurance and liquidity support for banks regardless of ownership.
- EU-based parent banks pledging to recapitalise and refinance their subsidiaries in the transition countries, as well as broadly maintain exposures in the most hard-hit countries with IMF programmes.
- Home governments permitting bank groups to access national packages for their whole operations, including subsidiaries in the region.
- IFIs announcing financing packages within their respective mandates.

3 EBRD FINANCIAL SECTOR ACTIVITY BEFORE AND DURING THE CRISIS

3.1 Implementation of the previous strategy

The Bank's first Financial Sector Policy was approved by the Board in 1992. Recognising the virtual absence of effective financial institutions in most COO, the principal objective was the *establishment of market oriented financial institutions, Central Banks and Regulators/Supervisors*.

The second Financial Sector Policy was approved in 1996. The key objectives were *institutional strengthening and intermediation*. The Bank recognised the importance of institution building if there was to be a lasting impact from its efforts, and that the desired impact would only be achieved if the banks were willing and able to provide financing to the real economy. While loans to banks continued to be the largest component in the financial sector portfolio, there was an increased focus on equity investments in banks. Investments in equity funds also experienced rapid growth, through both donor sponsored funds and EBRD participation in private equity funds, mainly focused on Central Europe.

The third and current Financial Sector Policy was approved in 1999. The key themes of this policy were *confidence and competition* addressed through a country-specific operational approach that also targeted the non-bank financial sector for the first time. These themes reflected the impact of the 1998 financial crisis, when the banking sector in the region suffered a severe loss of confidence. The relatively rapid return of bank deposits in most countries of the region since the sharp outflows in autumn 2008 is a clear demonstration of the progress made by banks and regulators over the last decade in rebuilding confidence and public trust, despite the many challenges that remain.

EBRD's financial sector portfolio has more than doubled since 1999 with major features as follows:

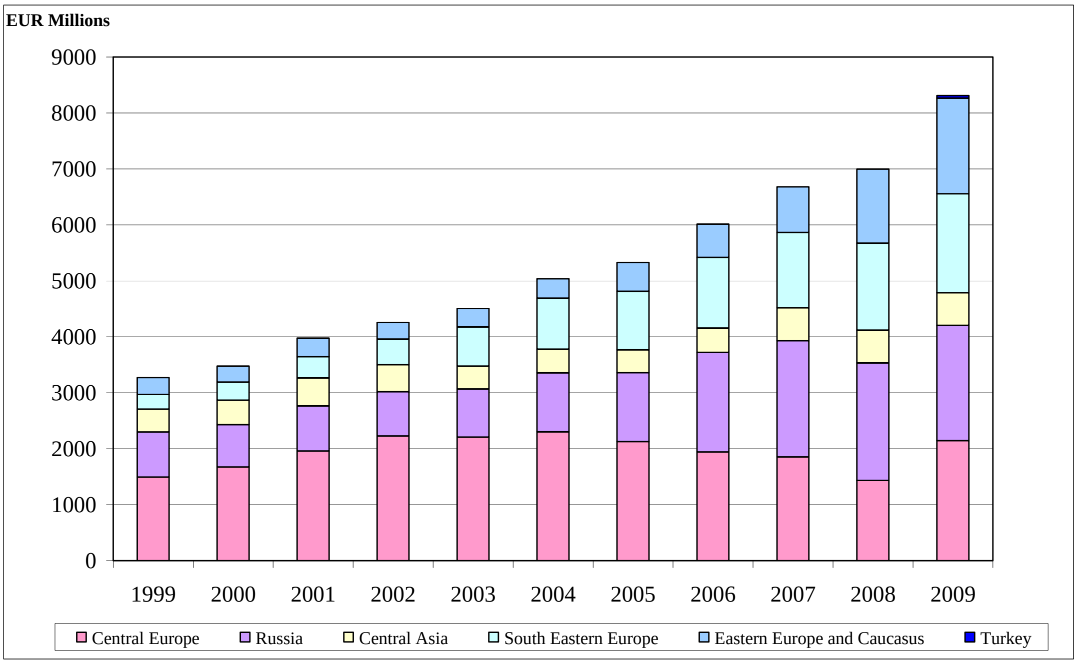
- Geographic diversity through implementation of projects in every COO, accompanied by a geographic shift to the south and east.
- Provision of a diverse set of products, going beyond traditional debt and equity to include quasi equity and capital markets instruments.
- Highly successful equity investments including in the context of privatisations with important institution building and corporate governance achievements and profitable exits.
- A strong impact in Early Transition Countries (ETCs), both in number and quality of projects.
- An extensive TC programme with €460 million contributed by donors to financial sector related consultancy projects since establishment in early 1990s and more than €100 million for incentive payments.
- A vigorous crisis response by the Bank across the region in late 2008 and 2009.

There are currently 768 (694 active projects with banks and non-banks and 74 with equity funds) projects in the financial sector portfolio involving 363 clients (201 banks, 108 non-bank financial institutions, 54 equity fund managers). The Bank has developed relationships with intermediaries that are well-placed to serve the real economy, with local banks featured prominently along with international banks (87 of the 201 partner banks are locally-owned).

3.2 Evolution of the Financial Sector portfolio before and during the crisis

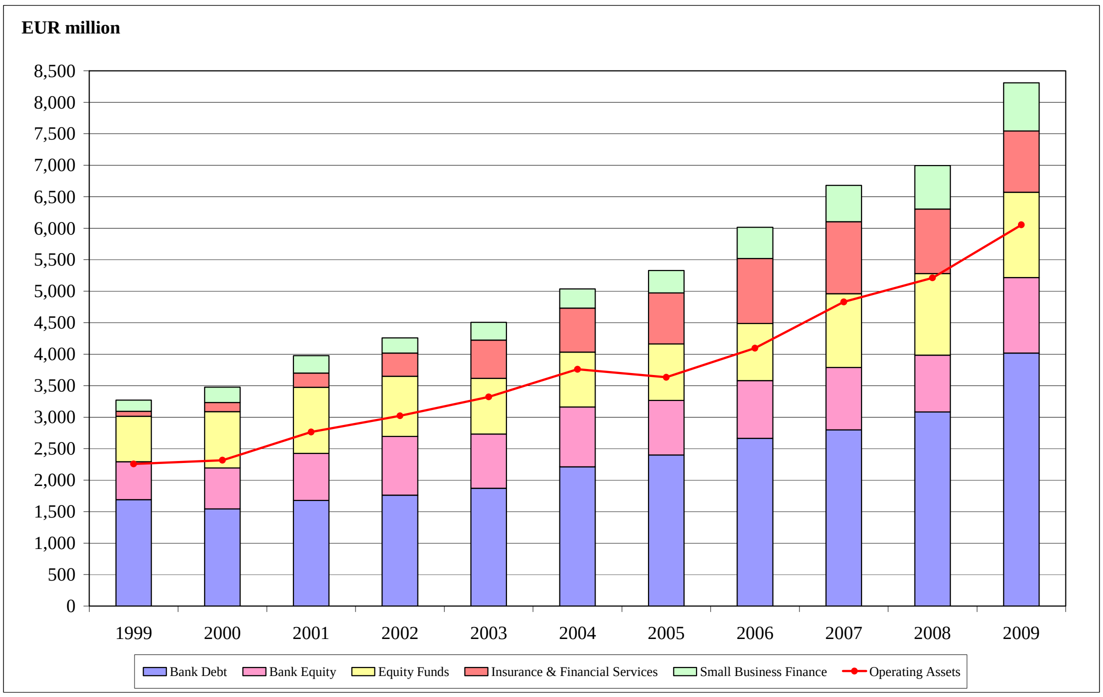
Since 1991, EBRD has committed €15.7 billion to over 1300 projects in the financial sector and by the end 2009 the portfolio had reached €8.3 billion.

Figure 1: Financial sector portfolio by country business group



There has been an enormous rebalancing of the portfolio in geographic terms over the last 10 years, with a marked shift south and east and the decline in business in Central Europe only interrupted by the ongoing financial crisis. The portfolio covering ETCs has now grown to €678 million, with 216 projects. Banks in countries such as Georgia, Latvia, Russia and Ukraine have been recipients of significant crisis response initiatives.

Figure 2: Financial sector portfolio by product groupings

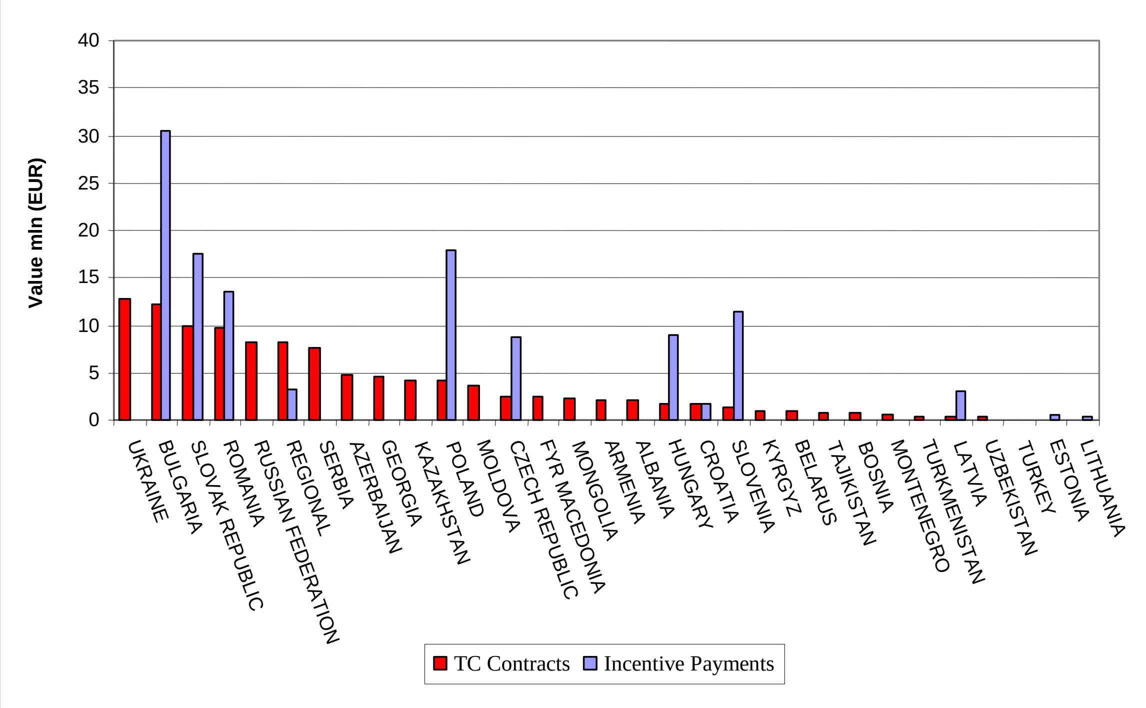


Since 1999:

- The bank debt portfolio has more than doubled to €4 billion. This growth is due to the introduction of credit lines supporting new products such as mortgage loans and energy efficiency, the expansion of key products such as MSME financing and trade finance and new approaches such as the medium sized co-financing facility. These priority products are serving important segments of the real economy which the Bank has continued actively to support through the ongoing crisis.
- There have been 64 new bank equity investments including 13 related to privatisations. These investments have been made across the region (11 in Central Europe, 9 in Central Asia, 15 in EEC, 13 in Russia, 16 in SEE) and are central to the Bank's commitment to build strong financial institutions on the basis of sound banking principles and good corporate governance. During this period the Bank has also exited from 58 banks, generating capital gains of over €1.8 billion.
- The Bank has remained a significant supporter of the private equity fund sector as a means to providing much-needed equity finance to SMEs and has invested in 66 private equity funds, of which 25 have been new start-up funds and 41 follow-on funds. The Bank has maintained its commitment to this sector through the business cycle, while seeking to push the boundaries of private equity further south and east and promote innovation in fund design and objectives.
- The Insurance and Financial Services portfolio has grown from €77 million to €973 million and now includes 93 projects covering 23 countries. The non-bank sector will continue to be critical to support the Bank's efforts to develop long-term local currency funding and local capital markets.
- Geographical outreach for the Bank's support for MSE finance has increased from 5 countries to 22 countries. EBRD is currently providing micro and small business financing through 109 intermediaries, including 34 non-bank financial institutions.
- The Bank has used from €20 million to €30 million annually for TC to:
    - Promote development of market-oriented financial institutions and institution building.
    - Facilitate the introduction of priority products such as sustainable energy.
    - Engage in policy dialogue and direct assistance to strengthen regulatory & legislative frameworks.

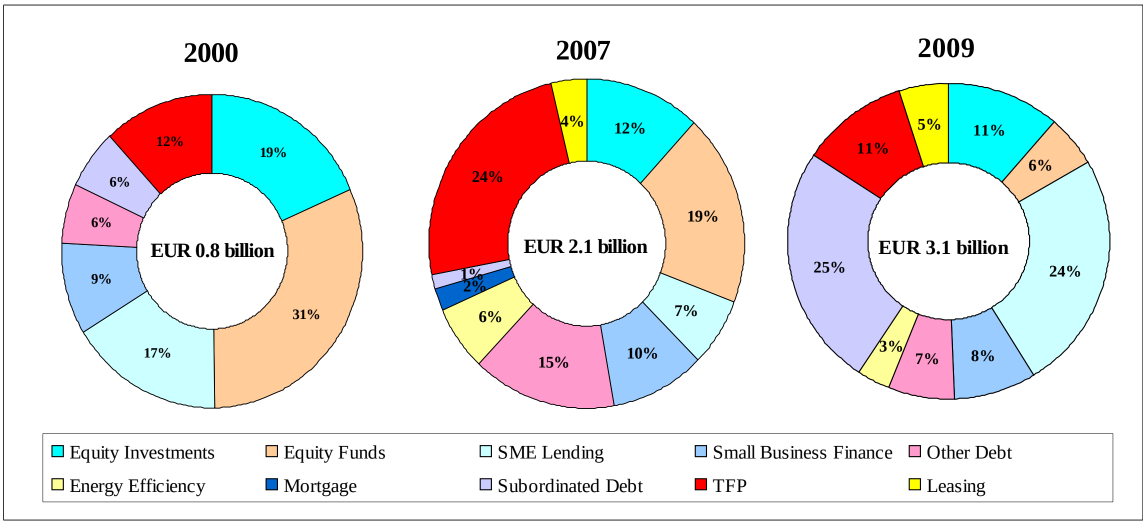
In addition to the TC assistance, grant funding has been used in the form of incentive payments, when additional support is needed for EBRD's clients and their sub-borrowers to achieve the Bank's objectives in priority areas such as MSME financing and energy efficiency.

Figure 3: Value of TC Contracts and Incentive Payments by Country 2003-2009



The Bank has adapted its product focus and introduced new products as the financial markets developed and clients' needs changed. Particularly noteworthy is the impact of the Bank's first phase crisis response, which has changed the product mix in favour of subordinated debt and SME credit lines in 2009.

Figure 4: Annual business volume in the financial sector by product, 2000, 2007 & 2009



Crisis Response

Helping to restore confidence in the financial sector has been a fundamental objective of the Bank's response to the financial crisis. The Bank has actively led and pursued dialogue with all stakeholders, including IFIs and home-host authorities, to ensure alignment of interests and views which has resulted in financial packages to strategic parent banks and local systemically important banks.

The second phase of crisis response has involved the Bank providing support for balance sheet restructuring, sector consolidation and restoring financing to the real economy. This has been accompanied by policy dialogue, focused on key vulnerabilities and problem areas. Several key instruments and approaches are being employed:

- Tier 1 capital to respond to currency devaluation and/or increases in non performing loans (NPLs) or to strengthen balance sheets ahead of merger or acquisition activities.
- Tier 2 capital in the form of subordinated loans to meet the need for increased capital while addressing both risk and/or valuation concerns or, as in some existing investments, where the proportion of EBRD ownership cannot be increased.
- Senior credit lines to banks and leasing companies to provide financing for MSMEs, seeking to mitigate the impact of deleveraging on the MSME sector which is starved of funds. While in some cases disbursement has been slower than expected and most of the Bank’s partners have not increased their loan portfolios, EBRD’s funding has nonetheless helped to ensure a more gradual deleveraging than would otherwise have been the case.
- Senior credit lines to provide financing for the priority area of Energy Efficiency.
- Trade Facilitation instruments, both guarantees and cash advances, to support trade.
- A cross currency swap mechanism for banks to reduce the large structural currency mismatches on their balance sheets.
- Enhanced support for private equity funds in a difficult fund raising environment to maintain the flow of equity to the SME sector.

Trade Facilitation Programme (TFP)

The availability of financing for trade had been identified by the G20, IFIs and a range of experts as an essential element in responding to the financial crisis and in accelerating the recovery process. The Bank took early steps to increase the availability of financing under its TFP by increasing the exposure limit at any moment in time to €1.5 billion. When this was presented to the Board in February 2009, the expectation was that the withdrawal of trade lines to banks in the EBRD’s COO from international banks would generate a substantial increase in demand for the Bank’s programme.

In 2009 trade volumes fell dramatically and EBRD’s client banks showed reluctance to provide financing to their clients. This development was unexpected, given that most foreign trade transactions can now be financed only with risk cover and funding provided by foreign export credit agencies and IFIs. Some signs of recovery are now visible, but volumes are expected to increase only gradually.

Technical Co-operation

In late 2008 and throughout 2009 the Bank provided various crisis response packages to financial intermediaries across the region. To accompany those investments, as well as to assist in stabilisation of the financial sectors, TC funding totalling EUR 23 million was approved to address the issues related to the financial crisis and to bridge the skill gaps.

The focus of the majority of TC assignments was on risk management, particularly client management and workout of Non-Performing Loans (NPLs)

Since the beginning of the crisis, five programmes for crisis response have been established:

- Framework for Russian regional banks for assistance and training in loan workouts and corporate recovery for Russian banks.
- Regional framework for institution building and targeted crisis response to engage consultant firms for larger projects.
- Regional framework for targeted crisis response with a panel of individual consultants for smaller projects.
- Framework for Ukrainian financial institutions for institution building and crisis response.
- TFP Programme comprising 6 separate assignments and including training on utilisation of cash advances under TFP Revolving Credit Agreements and handling bad debt and structuring during a crisis.

Individual assignments under these programmes were tailored to the specific needs of the partner financial institutions. Areas that required review and upgrading were, and in many cases still are: loan workout and corporate recovery, risk management, liquidity management, improved supervisory board oversight particularly with respect to risk management, introduction or improvement of stress testing, credit underwriting procedures, enhanced internal audit, introduction of or improvement of corporate recovery actions, strategic realignment in light of changing competitive position, rationalisation and restructuring with corresponding upgrade of HR to manage it, improved asset and liability management particularly with respect to currency and maturity gaps.

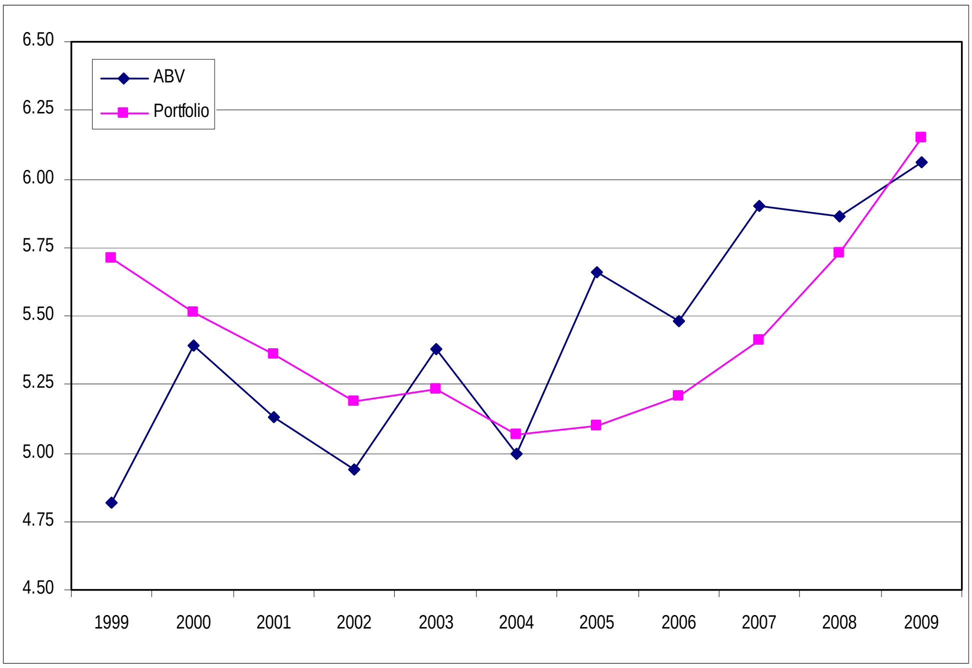
Legal Transition Programme

In late 2009, a new Financial Law Unit was established within the Bank's Legal Transition Programme to help remedy the shortcomings of legal frameworks that the financial crisis has exposed. Accordingly, more emphasis has been given to strengthening laws relating to debt restructurings and debt enforcement mechanisms. The Unit has also been developing its expertise in areas of high relevance to the Bank's financial sector investments, e.g., the corporate governance of financial institutions and the regulation of credit bureaus. All corresponding activities will be progressed in line with the strategy set out in the EBRD Legal Transition Programme 2010-2012 Action Plan (SGS09-341).

Impact of the Crisis on the Portfolio

The risk rating of the portfolio has increased in recent years as more business has been executed in the ETCs. This trend will continue as the Bank undertakes projects in the current environment with higher than usual risk in order to achieve transition objectives. As the crisis abates, risk improvements are likely to follow, particularly in Central Europe.

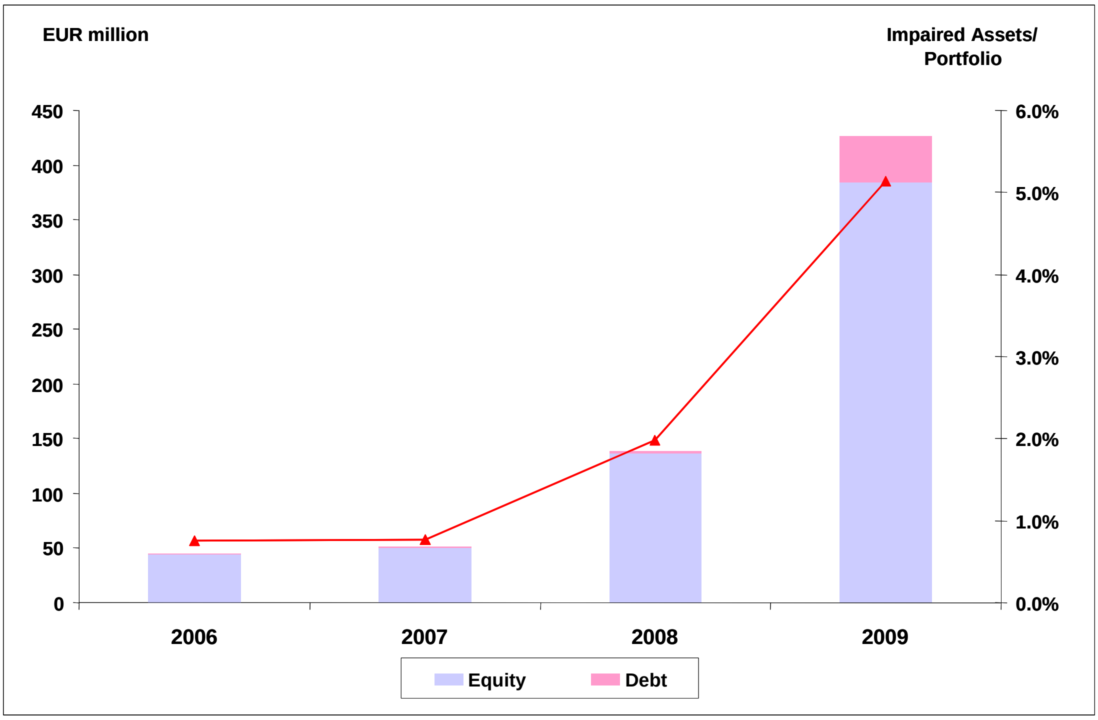
Figure 5: Project Risk Rating Movements, 1999- 2009



Portfolio quality has come under pressure and impairment is likely to increase as clients are faced with a prolonged economic downturn. Nonetheless, the portfolio has performed well so far, with impaired assets amounting to 5% of the current portfolio value (2% at end 2008).

As illustrated in Figure 6, the vast majority of these impaired assets relate to equity projects which experienced significant decreases in their fair values during the difficult period in the equity markets in late 2008 and throughout 2009. The Fair Value of the financial sector equity portfolio increased in the first quarter of 2010 by 18%, illustrating its sensitivity to market developments. Debt impairments have been few and are associated with a small number of banks in countries particularly hit by the crisis.

Figure 6: Financial sector portfolio – Impaired Assets 2006-2009



3.3 Transition impact

Assessment of Transition Impact

Since the last Financial Sector Strategy in 1999, OCE completed two assessments of the transition impact achievements in all countries and sectors through the Transition Impact Retrospective (TIR), which happened to coincide with two distinct periods of financial sector development before the crisis. TIR 2005 covered the period of 2000-2005, and was completed in 2005. TIR 2009, recently completed, covered the period 2005 through H1 2009.

According to TIR 2005, *during 2000-2005*, the Bank's activities in the financial sector were more successful than operations in all other sectors, owing to its strong support for the banking sector and MSMEs across the region. Supported by the reform progress, the Bank achieved significant or very significant transition impact in 32 country/sub-sector pairs in the financial sector and across a range of countries, or 44% of the Bank's total such ratings in TIR 2005.

According to TIR 2009, *during 2005-2009*, despite the large volume of engagement in the financial sector, the Bank achieved a relatively modest impact in the banking sector, compared to the previous five years. The Bank achieved significant or very significant transition impact only in 5 country/sub-sector pairs or 13% of total such ratings during this period. The modest transition impact masks significant distinct good progress in CIS and SEE countries through supporting development of MSME finance through banking and microfinance institutions. Technical assistance supported skills development for MSME finance, achieving an important impact in Armenia, Belarus, Kyrgyz Republic and Tajikistan. It has also had important impact in countries of SEE such as Bosnia and Serbia, and also in Russia and Ukraine. In the banking sector, the highest impact was achieved through support in restructuring privatisation, foreign entry, competition, and development of new products, such as in Armenia, Romania and Serbia. In equity funds markets the Bank has remained engaged in the CEB countries, particularly supporting the establishment of specialised funds (SME), but activities have been successful particularly in supporting the development of equity fund markets in Bulgaria and Romania.

The lower impact in the sector in the period preceding the crisis illustrates the importance of a broader engagement in sector reform for achieving a higher transition impact. Most projects in the sector focused on market structure and behaviour and less on developing market-supporting institutions.

Since 2008 the Bank has had a significant crisis response involvement in the financial sector across the region, in particular in the CEB countries, which has supported the banking system's resilience to the crisis. The transition impact potential rating of projects in the financial sector has increased in this period, with the percentage of projects rated good or excellent increasing from 83% in 2007 to about 90% as at year end 2009, largely due to better-rated crisis response projects.

The transition objectives of projects in the financial sector have also changed. In response to the crisis most of projects have focused on demonstration effect of restructuring (including adjusting business models towards long-term sustainability) as well as market expansion (including support to restarting of lending by banks). The projects are less focused on demonstration effect of new ways of financing activities as the syndication markets have remained closed.

An important lesson learned during the crisis is that influencing institutions often involves difficult coordination issues both at the government levels and at market participants' levels, which in turn require concerted efforts by many players, including other IFIs. Accordingly, the Bank has recently started initiatives focusing on improving the institutional environment for the financial sector together with other IFIs.

4 REMAINING TRANSITION CHALLENGES

This section describes transition challenges in the financial sectors of the Bank's COO as discussed in two recent policy documents, including the 2010 Capital Resource Review 4 (CRR4) and the 2009 Assessment of Transition Challenges (ATC).

The global financial crisis has had an effect both on the size and nature of the transition challenges in the region. In particular, the crisis put the financial sector in the region to a test and revealed both weaknesses and vulnerabilities while emphasising the role of strong institutions in ensuring stability in the system and minimising the effect of the crisis. A summary of transition challenges for all COO and all main sub-sectors is included in Annex I.

South-Eastern Europe

Transition challenges are predominantly medium and large, with Romania and Bulgaria rated somewhat better. In the two EU member states, regulations and institutions have come into alignment with EU standards, though implementation still needs to become more effective in many instances. In all countries banking supervision did not fully respond to the challenges posed by rapid market development, inflows of foreign credit and foreign ownership in the sector**.** It is important to give increased attention to burden sharing arrangements between home and host country authorities.

There are still significant transition gaps in MSME finance throughout the region. Financing is limited in rural areas and outside major cities, and for small agricultural enterprises. The development of local money and bond markets can be an important objective in Serbia and Romania, where uncertain integration into the eurozone will continue to pose currency risks for the foreseeable future and local liquidity is large enough to support local markets. Commercial private equity remains in its early stages, and the region has so far not attracted substantial interest from international private equity funds. Local currency money and securities markets remain underdeveloped, thereby locking in the already high currency substitution in these countries.

Eastern Europe and the Caucasus

Transition challenges in Ukraine, the largest country in this region, remain medium in both bank and non-bank sectors. The entry of a number of international banking groups since 2004 has supported bank governance and secured access to funding and capital in the current financial crisis. While very strong capital flows to the sector resulted in rapid credit expansion up to mid-2008, the crisis has also exposed important weaknesses in the system. Insurance legislation and regulation have improved in recent years, though the pension system is yet to undergo major structural reform. Lending to MSMEs suffered during the crisis, as did trade finance, as risk aversion increased. The institutional environment for MSME lending needs substantial strengthening. Progress has been made in securities legislation, although enforcement remains poor, and a viable private equity industry is only gradually developing. Despite large issuance in equity and private bond markets, market liquidity remains very thin and domestic institutional investors near-absent, which undermines the potential of market-based finance.

In the five other countries of the EEC region, financial sector transition gaps are predominantly large. The improvement in the Georgian banking regulation contributed to a closing in the transition gap in the banking sector to medium, importantly by raising corporate governance standards and enforcing greater transparency of bank ownership. However, regional turmoil and the international financial crisis both led to a dramatic slowdown in bank lending and serious vulnerabilities have since been exposed, in particular with respect to the need for improvement in risk and portfolio management.

Opportunities for the further development of MSME finance exist in all countries in the region, as there are still low levels of financial depth among MSMEs, which tend to seek alternatives to bank loans to finance investment and working capital needs. The lack of efficiently operating and comprehensive credit information services for smaller loans and weak legal frameworks for enforcing collateral and bankruptcy procedures is a clear impediment for MSMEs' access to finance. Competition among the MSME lenders needs to be enhanced, especially in rural areas. As in other less advanced transition countries, commercial private equity firms are absent, and with a few exceptions there has been only very limited interest by international private equity funds. A challenging business environment, limited investment opportunities and poor exit prospects all limit the possibilities to raise finance through this channel.

Central Asia and Mongolia

In this region, Kazakhstan was the first transition country to be directly impacted by the crisis in the international financial markets in 2007. After years of rapid growth in bank lending, fuelled by foreign borrowing, credit growth came to an abrupt halt. The state has significantly increased its involvement in the banking system, not least through taking minority and majority stakes in several systemic banks. The global financial crisis has not merely led to a reduction in the external funding available to Kazakh banks, but it also exposed a number of underlying and deeper vulnerabilities of the banking system, which explain the widening in the banking sector transition gap assessment to medium.

Access to finance remains an important impediment to MSME development in Kazakhstan, in particular in rural areas. The legislative framework for insurance almost fully meets international standards, and there has been a rapid development of private pensions in recent years. The development of the Kazakh securities market has progressed, but challenges remain. Securities legislation continues to show some serious weaknesses even though a long-awaited Anti-Money Laundering Law has recently been adopted. A private equity culture is only very slowly emerging, with one relatively well-run fund still present at the moment. The government intends to play an active role in private equity and venture capital as well.

The less advanced transition countries in the Central Asia region, in particular Uzbekistan and Turkmenistan, remain on the periphery of global financial markets and are likely to be less impacted by the retrenchment in financial integration. These countries show predominantly large transition gaps across all areas of the financial sector portfolio. Banking sectors are very shallow, with Turkmenistan showing the lowest ratio of credit to GDP in the transition region. State ownership and/or heavy government involvement and directed lending still characterise the sector in both Uzbekistan and Turkmenistan and, to a lesser extent, in Tajikistan. MSME lending takes on particular importance in Central Asia and Mongolia to fund private enterprises and may also play a role in smoothing consumption patterns in countries that have recently seen a sharp reduction in their remittances inflows (e.g. Kyrgyz Republic and Tajikistan). However, poor collateral laws and the absence of well-functioning information sharing arrangements (e.g. credit registries) significantly impede the development of this sector (with the exception of the Kyrgyz Republic and Tajikistan where credit bureaus have been set up). Banking sector consolidation and improvements in corporate governance continue to be a challenge in most countries in Central Asia and Mongolia. Commercial private equity is largely absent as a funding source within these countries. Recent and very limited interest of international private equity funds has disappeared. Challenging business environments, limited investment opportunities and uncertain exit opportunities all hinder the development of this sector.

Russia

Although some improvements have been made in recent years, transition challenges in Russia's financial sector remain significant. The gap has narrowed in the banking sector, where the authorities advanced regulation, importantly in response to the challenges posed by the financial crisis since mid-2008 (e.g. through the facilitation of bank mergers, or greater requirements imposed on bank capitalisation). However, the underdevelopment of many market segments (e.g. mortgages, or lending in the more remote regions), and of MSME finance (where the gap remains large) still pose important challenges. The legal and regulatory framework is relatively weak, with credit registry and private credit information bureaus at an early stage of development, along with collateral and bankruptcy legislation supportive of MSME lending. One of the key challenges will be to facilitate restructuring of medium-sized and regional banks, including improvements in risk management and liquidity management.

The underdevelopment and institutional shortcomings in the non-bank financial sector, evident for instance in the fragmentation of the insurance sector where tax optimisation schemes were only recently banned, highlights the shortcomings in developing a more fully articulated financial sector. Although the private equity industry is now well established, development of an institutional investor base (including pension funds, insurance companies, and asset managers) that will become core players in the market will be important for building up of local capital markets.

Central Europe and the Baltics

The countries in this region have important remaining challenges in the financial sector. Although transition gaps in the eight banking sectors were assessed as small (with the exception of Latvia), the three Baltic countries and Hungary continue to undergo severe stress in bank funding and asset quality. Weaknesses in bank funding models and lending standards are more apparent now than before the regional financial crisis. Foreign currency denominated retail lending in the region also deserves attention. As experienced during the crisis, with some notable exceptions, regulatory frameworks need to be further strengthened. Once credit growth picks up again, regulations will need to keep better control over potentially excessive credit growth and over banks' foreign currency exposures, particularly to un-hedged borrowers. Moreover, the weakness of cross-border regulations, particularly the lack of crisis management and burden sharing arrangements between home and host country authorities, is a key challenge.

The region's financial sector currently is not in a position to finance effectively the real economy, especially SMEs. The lack of financing to the corporate sector is compounding the already severe effects the crisis is having on SME supplier chains and unemployment. Innovative companies still do not have access to necessary funding from the capital markets for productivity enhancing investments.

Given the disruption in financing through bank credit there is renewed interest in the development of local money and securities markets. Hungary and Poland have sizable domestic government bond markets, although until a clear timetable for euro entry exists more could be done to stimulate domestic currency instruments, including corporate bonds and covered bonds issued by banks. As a result of the crisis, domestic equity markets are similarly illiquid in all countries except Poland and Hungary, although international markets in neighbouring countries may offer greater scope for issuance of and trading in equity. In many countries there was a significant presence of private equity firms before the crisis, an important source of capital and managerial skills for those companies in an expansion or restructuring mode, or for those too small to access public equity markets. Venture capital, vital for start-ups and growth companies, remains under-developed.

Turkey

Improvements in banking supervision and regulation since the 2001 financial crisis contributed to the resilience of the Turkish banking. At the same time, the Turkish financial sector remains relatively small in size and narrowly based. The sector is highly concentrated and state ownership accounts for about 30% of total assets.

Institutional reforms, such as improved coverage of credit information services, better enforcement of bankruptcy laws as well as a geographically unified collateral registry would help to stimulate bank lending to small businesses. Turkey is aiming to align its legislation and supervision with the EU framework. Turkey is one of only three COO with a small transition gap in private equity and capital markets. The domestic equity market is among the deepest and most liquid of any country of operation, providing a viable source of capital funding to large enterprises in conducive market conditions.

5 LESSONS LEARNED AND IMPLICATIONS FOR THE BANK

The Evaluation Department had prepared a comprehensive report on the implementation of the 1999 Financial Sector Operations Policy in 2007. The key findings of this report are noted in Annex 2. Many of the recommendations in that report have been implemented, others have been considered in the development of this strategy document. There are important lessons learned from the crisis and these are discussed in this section.

5.1 Lessons Learned From the Crisis

The global financial crisis, which began in the United States mortgage sector, soon spread to the rest of the developed world as markets reassessed the quality of their portfolios of asset-based securities. The causes have been debated at length but can be distilled into a search for yield, supported by ever-increasing leverage and a supply of structured products that appeared to offer above-average returns at apparently acceptable risk. At the heart of the issue were very liquid financial markets, low interest rates and a weakening of credit standards inherent in the originate-to-distribute model that had been adopted by many financial institutions. Financial engineering and a seemingly attractive combination of risk and reward induced institutions and investors to take risks and to employ risk mitigants that were not always well understood – by banks, rating agencies, regulatory authorities or investors. As the liquidity on which these leveraged structures depended dried up, trust in the prevailing financial model evaporated and the result was a general aversion to any form of risk and, in effect, a freeze of the financial system that was only addressed by unprecedented government intervention. Post crisis global challenges include the need to improve regulatory frameworks, enhance corporate governance of financial institutions and improve mechanisms for cross-border regulatory coordination.

The crisis took some time to spread to the Bank's region, but did so in dramatic fashion after the failure of Lehman Brothers in September 2008. Banks in COO were not exposed to the same risks that had threatened to bring down the financial systems in more developed markets.

Banks had not engaged in sub-prime lending of the kind seen in the United States. For the most part, mortgage borrowers had been subject to reasonable loan to value and payment to income levels and the quality of these portfolios held up well as the crisis progressed. Nor were banks creating or investing in esoteric structured finance products or, as a group, pursuing particularly risky activities in the search for increased yield. While competitive pressures and the push for market share were driving rapid growth looser risk management standards, banks remained focused on their local markets and on providing funds to the real economy, meeting many years of pent-up demand.

However, the crisis did expose some “home grown” vulnerabilities that generated a dangerous loss of confidence and for a period of time threatened systemic stability in several countries:

- Very rapid and unsustainable growth in credit flows.
- Heavy reliance on cross border foreign currency borrowing by both banks and other borrowers, with very little availability of reasonably priced term funding in local currency.
- Weaknesses in corporate governance and risk management practices that had been masked by a decade of growth and the perception of economic stability.
- Shortcomings in regulatory systems that, not unlike those in many other countries, did not fully recognise or react to some of the risks faced by institutions and financial systems.

The four key lessons learned from these events and the vulnerabilities that have been highlighted are:

- The need for the Bank proactively to address the over-reliance on foreign currency loans in the region, in the short term by promoting a balanced approach, based upon reasonable credit growth, suitability of lending products for particular borrowers, proper disclosure of risks and appropriate risk management. In the longer term a deeper and more concerted effort alongside other stakeholders to strike the right balance between ensuring the availability of funding necessary to support growth and overall economic stability. A number of initiatives are now in process and are discussed below. Approaches will need to be carefully calibrated for different situations in countries facing a wide variety of issues.
- The need for the Bank to take a comprehensive view of financial system development, focusing more on some of the building blocks of sustainable financial systems, such as the support network for local capital markets. The Bank will need to consider creative and unconventional approaches to catalyse development in this area and is likely to need to continue to play a key role in bringing interested parties together to maintain momentum. Efforts will need to be focused on countries where at least some of the prerequisites for success are in place. Consideration will also need to be given to a more regional approach to ensure there is sufficient critical mass for market viability.

ernance and institution building. The Bank will need to be consistent about ensuring that its partners adhere to appropriate risk management standards to avoid a repeat of the recent overheating.

- The important role played by macroeconomic and systemic developments, and the need for broad based cooperation with and among the authorities, EBRD's clients and other IFIs.

5.2 Implications For the Bank's Approach to the Financial Sector

In the context of the previous Financial Sector Policy, the Bank has been very effective in building relationships, delivering projects and using institution building TC to broaden the availability of financial services to the region. EBRD's activities in the financial sector have clearly improved access to finance and have enhanced the quality of financial services. The new strategy will seek to adopt a broader view, while maintaining at its centre a focus on effective project delivery.

The major implications for the Bank's approach going forward are:

- The need for a comprehensive approach, with more attention to the business and regulatory environment that underpins the sector, improving the capacity of the region to become more self sufficient and to rely more on locally raised funding. This will entail closer engagement with clients, the authorities, other stakeholders and other IFIs.
- The Bank will continue to derive influence from the delivery of sound projects that meet the needs of clients in the region; these projects provide the foundation for the Bank's credibility in the sector.

The following section outlines the strategic objectives and the operational priorities to achieve these goals, driven by the transition needs in the region and by the lessons derived from the crisis.

6 STRATEGIC OBJECTIVES AND OPERATIONAL PRIORITIES

The overarching objective for the Bank in the financial sector area is to address the legacy of the crisis and support the recovery and future economic growth with sustainable financing for the real economy in the COO. The Bank's approach will reflect the specific issues and needs for financial sector development in each country.

6.1 Strategic Objectives

The Bank will have five strategic objectives in the coming period:

- **Complete the crisis response activities and stimulate lending to the real economy**

  - The crisis is far from over and addressing its legacy through recovery and restructuring of NPLs and responding to institutional vulnerabilities remains a key priority.
  - Lending to the real economy must re-start for sustainable growth.
  - Limited access to banking services and funding for under-served segments, such as MSMEs, remains a serious concern.

- **Help develop local currency and capital markets**
  - Local or regional capital markets are an essential element for effective and sustainable savings and investment in local or regional currency.
  - This requires the development of a broad range of non-bank financial institutions and financial infrastructure, with the Bank providing a platform for policy dialogue, TC and investment to catalyse the process.
  - The approach needs to be (i) holistic, taking account of all the key elements of local currency market development such as macroeconomic policy, regulatory framework, market development and market infrastructure; and (ii) country-specific, as the reasons for the widespread use of foreign exchange and weak capital markets differ from country to country. Prospects for eventual euro-adoption in the case of EU members and EU enlargement countries (where applicable) also matter, although more extensive reliance on domestic sources of funding through local capital market development is advantageous irrespective of eventual membership in the euro zone.
  - Coordination in this area with other IFIs and the European Commission is key.

- **Assist with better governance, more sustainable business models and improved risk management of banks and non-bank institutions**
  - Banks' business models will need adjustment to reflect reduced availability of foreign financing, increased awareness of the risks of foreign currency borrowing and lending, and slower growth of balance sheets.
  - Risk management to be reviewed and improved through both engagement with borrowers/investees and TC.

- **Support consolidation, privatisation and re-privatisation/government exits from the banking sector**
  - The structure of the banking system in some countries is sub-optimal, with fragmentation demanding consolidation of some smaller players and state ownership to be reversed in parts of the region.

- **Support new regulatory frameworks in close coordination with IFIs, including in the area of cross-border regulation**
  - Key role for IFI coordination, public-private sector coordination along the lines of the Vienna Initiative.

These objectives are necessarily ambitious, reflecting the complex and rapidly changing needs of the region's financial sectors; delivering on them will require that the Bank continues to work very closely with all stakeholders.

6.2 Operational Priorities

The strategic objectives will be translated into operational priorities, which will form the basis of the Bank's delivery of projects, TC and policy dialogue.

6.2.1 Complete crisis response and stimulate lending to the real economy

- Promote and participate in balance sheet re-structuring and re-capitalisation of banks, with a particular focus on equity transactions.
  - Provide additional capital for banks which are likely to be successful providers of financial services in the medium term.
  - Focus on Tier 1 capital but be prepared to offer Tier 2 or convertible products where appropriate.
  - Regulatory developments in the financial sector will influence the choice of equity investments.

ADVANTAGES OF EQUITY
Equity investment is a key tool available to EBRD to foster transition and to promote private and entrepreneurial initiative. The Bank is a minority investor, typically acquiring stakes in the range of 5 to 30%. As an equity investor EBRD acts as a risk taker and fulfils the roles of: • investment partner • institution builder • professional minority investor • promoter of international standards • catalyst for entry of new investors. While transition and additionality can be achieved irrespective of the financing instrument, the characteristics of equity provide particular advantages to promote transition and additionality. Equity investments require a high degree of engagement, including: **- Fostering and demonstrating the highest corporate governance standards** Compared to covenant monitoring in debt transactions, equity investments are better suited to achieving a direct and more nuanced impact on corporate governance, policies and development including transition impact measures. This includes promoting institutional development and introducing best practices, promoting minority shareholders' rights, increasing transparency and management accountability, promoting establishment of audit and remuneration committees, adopting clear rules of business conduct and promoting the adoption of environmental, social and health and safety policies in accordance with EBRD requirements. This also includes promoting best practices with respect to equal opportunities for men and women through the investees' human resources policies and practices (e.g. work-life balance, flexible working hours, family friendly initiatives, etc). **- Broader contribution to the investee company's development** In addition to contribution to governance issues, EBRD can influence the company's business strategy and support value creation, with frequent contact and close attention to the company's everyday activity. EBRD can also facilitate transfer of financial skills and technology, provide political comfort to sponsors, act as an "honest broker" between local and international or institutional shareholders, and facilitate the dialogue between investors and local authorities. **- Board representation** Appointing the Bank's nominee to an investee's Board of Directors can be the most effective way to achieve corporate governance objectives and to facilitate close monitoring of the Bank's investment. Other advantages include the opportunity to identify issues at an early stage and discuss their resolution in an appropriate forum. Having a nominee Board member can enable the Bank to make an impact disproportionate to its shareholding percentage. Bearing in mind that the appropriate skill set and expertise are deciding factors, the Bank will strive to increase the number of female nominees on investees' Boards.

The decision on each equity investment is based on risks and returns with appropriate measures taken to mitigate the risks and maximise returns. Detailed due diligence before the investment, careful selection of partners, strong legal agreements and close engagement post investment are among the measures needed to ensure a successful transaction.

ROLE OF EQUITY IN FUTURE FINANCIAL SECTOR OPERATIONS

While a number of the largest banks in the region have needed to raise additional capital to cushion against the effects of the crisis, more equity is likely to be required as NPLs peak and growth in lending returns. Regulatory improvements drawing on the lessons of the crisis that are under consideration by various national and international bodies are likely to include measures aimed at increasing regulatory capital, such as higher risk-weighted capital requirements, countercyclical loan-loss provisioning, formal leverage ratios, contingent and convertible capital, phasing out tier 2 capital, and special measures for systemically important institutions. If adopted, these measures, as well as authorities' resolve to encourage new lending, would exert further pressure on banks to increase capital. As a result, some institutions may be forced to de-leverage their balance sheets to come into compliance with regulations or may be forced into alternative ownership.

These challenges present an opportunity for the EBRD to increase its transition impact in the sector through equity investments in local banks. As strategic investors look to their own post-crisis challenges, EBRD is one of the few sources of non-state capital. By acquiring or increasing stakes in financial institutions, the Bank would be able to support private sector competition and reduce excessive de-leveraging.

Building upon many years of experience of successful investment in the financial sector, the Bank will continue to seek opportunities to extend the equity portfolio in coming years. The Bank will participate with new equity capital for existing and new clients which require capital to support increased lending to the real economy. Equity will also be an important component of efforts to develop some of the building blocks of financial infrastructure, since many of these companies will be in a growth phase where equity investment may be more appropriate to their capital structure and cash flows. Increased equity operations are likely to require significant TC resources.

- Take steps to re-start lending to the real economy on a significant scale and a sustainable basis:
  - Provide long-term funding for on-lending to all parts of the economy. Initially, this could well be largely to the midsized corporate sector but will also need to address targeted priority activities, such as MSMEs and Energy Efficiency.
  - Provide continued support for retail lending, including mortgages and consumer finance, provided they are undertaken on a suitably prudent basis, follow best practice standards and reflect an assessment of the prevailing regulatory environment.
  - As economic recovery gathers pace, financing under the TFP will be particularly needed by banks and their clients, who have lost access to trade finance facilities from foreign commercial banks, insurance underwriters and export credit agencies.

- Develop risk sharing mechanisms (at individual sub-project or portfolio levels) where risk aversion may be a barrier to increased lending activity, including extended use of MCFF.
- Syndicated lending to banks in COO has a role to play in providing scarce longer-term funding. The Bank will carefully engage to facilitate syndicated loans where such loans form a component of a diversified funding base of client banks.

➢ Explore alternatives for supporting MSMEs beyond regular credit lines:

- With risk aversion likely to persist for some time, credit lines on their own, while necessary, may not prove sufficient for maintaining and/or expanding access to funding for the MSME segment. Under the new strategy, early attention will be given to considering whether additional measures, such as risk sharing, are necessary to encourage lending. The Bank will continue to explore with other IFIs and with donors arrangements that would reduce the risk faced by client banks by sharing some of their MSME risk on a portfolio basis.
- As the crisis draws to a close, the Bank's funding for MSMEs will be increasingly tied to incremental growth in MSME loan portfolios or to a proportional increase in MSME lending.

SUPPORTING SMALL BUSINESS DEVELOPMENT

The EBRD has long supported micro, small and medium-sized enterprises in the transition countries. These sectors are important sources of entrepreneurship, innovation and job growth, and have traditionally suffered from limited access to finance due to their small size, difficulties of screening their quality, lack of collateral and short credit histories. In the past, the Bank has used credit lines, equity funds and technical cooperation to support MSMEs. The Bank has also supported many non-bank institutions including microfinance institutions and leasing companies expanding into the MSME segment.

Additionality of the EBRD in operations with the MSMEs is likely to increase after the crisis. During the pre-crisis years, many private financial institutions entered this segment of the market and built institutional capacity for dealing with small borrowers. However, access of small enterprises to credit has suffered as banks have retrenched during the crisis and have downsized some segments, including the MSME segment. At the same time, the cost of finance has increased, thus pricing some smaller borrowers out of the market, although it should be noted that reliable access to funding is often of more concern to MSMEs than the cost of funds. The Bank is likely to remain additional in the MSME sectors not only in the ETC region, but also in many of the more advanced transition economies in the coming years.

The Bank will maintain its focus on the MSME sector while drawing lessons from the crisis. The objective will be to ensure that operations supporting MSMEs are designed to promote incremental portfolio growth as the economy recovers. It will also be important to balance the considerations of offering access to small borrowers in markets where local funding is limited and very expensive with the risk concerns of lending in FX. The Bank has encouraged, and will continue to encourage its partners to improve disclosure of foreign exchange risks to un-hedged small borrowers. The Bank will focus on the issue of sustainability of its micro-lending clients, encouraging local funding where possible and mergers and other efficiency enhancing strategies where appropriate, while at the same time helping these institutions to keep their MSME focus. The Bank will explore engagement with cooperative banks and credit unions as it seeks to broaden the availability of MSME financing. The Bank will also encourage and provide support to client financial institutions to promote and facilitate lending to women entrepreneurs, including staff training to ensure equal access to finance for women and men. Finally, the Bank will seek to develop and support financial infrastructure projects that can improve financial access and help lenders manage risk in lending to MSMEs, including credit bureaus, and mutual credit guarantee institutions.

CASE STUDY: FINCA

FINCA Armenia is the EBRD's first partner non-bank microfinance institution in Armenia. The demand for MSE funding outstrips the supply by a wide margin and the local financial sector does not deliver financial services to the micro entrepreneurs on a large scale, especially given the current environment of shrinking balance sheets. Entrepreneurs in the rural areas are particularly lacking access to financial services.

FINCA Armenia is a credit organisation regulated by the Central Bank of Armenia and is fully owned by FINCA International. The institution extends loans to MSEs across Armenia through a network of 16 offices. The loan portfolio data demonstrates FINCA's focus on the smallest entrepreneurs: the average loan amount outstanding is USD 880. The institution currently serves over 29,000 borrowers. Over 82% of FINCA borrowers are based outside Yerevan.

EBRD has provided a senior loan of USD 4 million for on-lending to MSEs. Both FINCA and EBRD follow a strategy of mitigating the foreign currency risks for both the institution itself as well as the MSE borrowers. The crucial feature of the loan agreement is that while the repayments are denominated in the USD, they are linked to US Dollar / Armenian Dram exchange rate. Due to FINCA's focus on very small loans and clients which are often considered as unbankable, margins are relatively high and it was possible to build in the US Dollar/Armenian Dram swap arrangements via The Currency Exchange (TCX), another EBRD supported project.

The debt financing is accompanied by technical assistance funding which is planned to focus on the overall institution building and strengthening.

- Financing through financial intermediaries will continue to play an important role in financing sustainable energy in the region by:
  - Expanding country coverage for Sustainable Energy Financing Facilities.
  - Broadening sectoral coverage in markets where credit lines have been put in place, to include SMEs and municipal.
  - Taking a strategic approach to the undeveloped market for residential energy efficiency through credit lines and mortgage financing.
  - Developing new instruments, including development of risk sharing mechanisms and special purpose funds.

DELIVERING ENERGY EFFICIENCY THROUGH THE FINANCIAL SECTOR

Since 2004 EBRD has been active in promoting sustainable energy investment through the financial sector. The Bank's Sustainable Energy Financing Facility (SEFF) is a specifically dedicated credit line to local financial institutions for financing sustainable energy investment projects. Building on EBRD's relationship with local financial institutions and making use of their established distribution networks and credit discipline, SEFF has proven to be an effective financing mechanism for small energy efficiency and renewable energy investment by bundling technical assistance, funding, market/distribution channels and financial incentives, if required, into one structure.

SEFF is one of the core components of the Sustainable Energy Initiative (SEI) which was launched in 2006 as the Bank's medium term strategy on climate change, and has been financing sustainable energy investments in industrial, residential and municipal sectors in more than 10 countries. Phase 2 of the SEI, introduced in May 2009, calls for a substantial scaling up of SEFF operations by deepening market penetration in existing markets such as Bulgaria and Ukraine and expanding geographical coverage in new markets, while developing new target sectors/sub-sectors (e.g. SMEs, buildings) and new products/instruments (e.g. equipment financing, risk sharing instruments).

- Securitisation and other forms of capital markets products in more simplified and transparent form are expected to return to the market. Investors are likely to be more selective and EBRD can play a catalytic role in re-introducing these important financing tools to the region[1]:
  - While the more complex and esoteric forms of securitisation and structured finance have resulted in significant and well publicised losses to investors, the more traditional and well structured asset classes such as prime residential mortgage-backed securities (RMBS), auto and consumer loans, leases, covered bonds and diversified payment rights for banks have continued to perform and repay on time through the crisis in countries such as Russia, Kazakhstan, Ukraine, Turkey, Bulgaria and Poland. Investors are noting this success, and in some instances indicating a preference for these structures as they slowly and carefully redirect their attention to these markets.
  - The EBRD can play a role to facilitate new issuance as an anchor investor, through increasing the deal size to make these structures more economic to clients, and to help with the asset liability mismatch for tenor and currency where investors may favour shorter tranches. Third party investors are expected to take significant comfort from EBRD support for these new issuances.

6.2.2 Local currency and capital market development

The post-crisis period presents 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 transition region.

Macro economic and regulatory conditions have become clearly more "local currency friendly," with interest rate differentials narrowing in most EBRD countries vis-à-vis the Euro or the U.S. dollar; new regulations favouring local currency lending to unhedged borrowers having been adopted in several countries; rating agencies declaring FX lending to unhedged borrowers a "structural problem" in emerging Europe; market players increasingly recognizing that even for countries which

[1] EBRD has invested in six securitisations in Russia. These have all performed well; four have been repaid, with the remaining two performing in line with the original projections. The key elements have been careful selection of clients, with risk management practices sufficiently well developed to cope with the sharp economic downturn, robust structuring and strict eligibility criteria for the underlying assets. For new deals, there is now significant crisis related historical performance data to inform asset selection.

eventually will adopt the euro a certain degree of domestic capital market development is not a *detour* but a useful element of preparation for euro adoption.

VULNERABILITIES IN LOCAL CAPITAL MARKETS
The global financial crisis has revealed several important financial sector vulnerabilities in a number of COOs. Relatively cheap and readily available external finance and weak macroeconomic and institutional frameworks led to excessive reliance on foreign savings before the crisis, making countries vulnerable to reversals of capital flows. Local capital markets and mechanisms for channelling local savings to the private sector have remained underdeveloped. Finally, much of the lending has been denominated in foreign currencies which, in countries which have experienced significant devaluations, has strained bank balance sheets and limited their ability to support economic recovery. **Although foreign currency lending has been a driver of financial deepening and growth in many countries, it can be excessive from the social perspective if allowed to run out of control.** Foreign currency lending may be socially excessive if individual exposures lead to an aggregate imbalance that can be aggravated in a crisis. This may be induced in part by economic agents expecting implicit exchange rate guarantees (moral hazard), or not being aware of the risks. For some, non-euro zone EU members expectations of an early euro zone entry and the associated false sense that the exchange rate would remain stable throughout the convergence process may have played a role in this regard. Reversing these trends requires that governments establish a credible track record of low and stable inflation and develop trust in domestic institutions. These are processes that are likely to take many years to lead to lasting impact.

- The Bank has embarked on a major project to support local capital market development and shifting to local currency funding and lending through a "holistic approach" to local capital market development that:
  - Identifies the overall conditions for local currency and capital markets development and coordinates with other IFIs for a consistent assessment and message across the region.
  - Assesses the state of such developments in the Bank's COOs.
  - Encourages needed policy and structural reforms for local currency market development in cooperation with other key stakeholders.
  - Supports local capital market development through the Bank's investment in market structures and instruments as well as through the Bank's funding and lending operations in local currency as conditions permit.
- Achievement of sustainable results will require a coordinated approach within the Bank, with critical contributions from OCE, Treasury, Banking and OGC. It will also require close cooperation and collaboration with a wide range of participants outside the Bank - clients, authorities and other IFIs. The overall approach is being crafted in a process that seeks to build on momentum and common ground established under the Vienna Initiative and is being conducted in parallel with this strategy document. The complicated dynamics of the approach will require some time to finalise to ensure effective delivery.

- Local currency lending in ETCs will be the subject of a dedicated review and evaluation of options as part of the overall process. It is recognised that significant challenges exist in lesser developed markets that may require tailor-made solutions.

    - The Bank will seek to strengthen existing delivery mechanisms, such as TCX and inflation-indexed instruments, to improve responsiveness to volatility in inflation and to lengthen fixed rate tenors.

- Implementation of the project is expected to enhance the ability of the Bank to deliver local currency lending to clients where appropriate and possible.

    - An important element will be the development of the conditions and financial infrastructure that make local currency debt attractive for both lenders and borrowers.

    - The conditions for local currency lending differ from country to country and different approaches and timescales will be required. Flexibility and creativity will be necessary to making meaningful progress, because actions and the Bank's longer term goals will need to adapt to the very diverse needs and policy aims of the countries of operations. It is clear that the development of local capital markets will require different approaches depending on the size of such countries, their timeframe for euro-adoption (where applicable) and the level of development of their financial infrastructure.

DEVELOPMENT OF LOCAL CURRENCY BOND MARKETS IN EAST ASIA
The Asia financial crisis in 1998 exposed many of the vulnerabilities in that region, including the shortcomings of local currency markets. Annex 3 provides some detail on the steps taken by East Asian governments in response to those shortcomings, and outlines some of the results that have been achieved. The Bank will seek to learn lessons from this and other experience in promoting local currency activity in emerging markets.

- Sustainability and stability of financial systems requires the development of sufficiently robust local or regional capital markets to channel savings and investments in an efficient manner and to support well functioning local currency markets.

    - This requires credible institutions to encourage and service long term savings and investment vehicles.

    - It also requires an effective financial infrastructure, ranging from good legislation to the nuts and bolts of payments systems, registries, transfer agents etc.

    - The Bank has a significant role through policy dialogue, TC, investment and its own Treasury activities to stimulate and support the long term development of a financial infrastructure that can underpin local capital markets.

- Progress in this area will be challenging and will require sustained effort while recognising that positive outcomes may take considerable time in some countries.

➢ Key areas for investment include life insurance and pension funds for long term savings vehicles, since the "demand side" for local currency products needs to be enhanced. These are challenging segments for the Bank, requiring recognition of the different investment criteria and characteristics of a long-term capital intensive business.

NON BANK FINANCIAL INSTITUTIONS

Non Bank Financial Institutions (NBFIs) have developed more slowly than banks in the region, in common with experience in many other emerging markets. Regulatory change has tended to be more limited than in the banking sector and the quality of regulation is often an issue of concern. In many countries pension reforms have been half-hearted and there is still reliance on the state rather than the private sector.

In much of Central Europe the insurance business has developed rapidly and penetration rates have increased, attracting many international players. In other COO, however, demand has been slower to develop, at least in part for historical or cultural reasons, and some parts of the industry have adopted less than transparent business practices and products. As a consequence, foreign investment has been less robust than in banking and uncertain business and regulatory environments have tended to magnify the risks involved of investing in a business, particularly life insurance, which can be very capital intensive due to the long period necessary to generate profit.

Properly functioning NBFIs are critical for developing sustainable local currency markets and local capital markets. Pension funds, insurance companies, asset management companies and investment funds provide vehicles that encourage and facilitate domestic savings, ultimately channelling them into the real economy. A long-term savings culture, which is at the foundation of a successful insurance and pensions industry, needs to be nurtured in much of the EBRD region, together with trust in the financial services industry. The Bank's involvement, both as an investor in individual projects and a facilitator of a consistent regulatory environment through policy dialogue efforts, is intended to support the broadening and deepening of the non-bank sector throughout the region.

Given the earlier stage of development of NBFIs compared to the banking sector, careful but extensive use of TC funds will be required to support policy dialogue. A two-pronged approach will be adopted that seeks to address shortcomings in legislation and regulation that act as obstacles to development of the sector while identifying projects that, with appropriate institutional strengthening, can provide demonstration effect to the market.

➢ Further investment is also required into basic utility type infrastructure such as card processing, registries, payments systems, credit bureaus, consumer protection structures, debt collection structures. Efficient and reliable payments systems are particularly important for the real economy, and especially for SMEs. These tend to be relatively small investments with low returns and high maintenance but are vital for the development of local financial markets.

FINANCIAL SECTOR INFRASTRUCTURE

Financial infrastructure remains underdeveloped in most COO. In more developed market economies, it includes credit bureaus, payments networks, exchanges, clearing houses, processing and other specialized service providers to the financial sector. Many of these institutions are either in their nascent form or still missing in the transition region. For example, the recent Assessment of Transition Challenges concludes that average coverage by credit registry and/or credit bureaux in the region is under 30%.

Financial infrastructure is important because it helps expand the market of financial sector products and services. In some cases infrastructure companies provide a product or service not otherwise available, for example ATM and POS networks. In other cases, infrastructure companies expand the capabilities, increase the efficiency, or reduce the risk of core institutions. Credit bureaux allow lenders to manage risk more effectively; exchanges and clearing houses allow pension funds, asset managers and other investors to more effectively trade securities. To date, the Bank's operations in this area have included equity in a card processing company and guarantees for deposit insurance schemes. The Bank has also provided TC for credit bureaux and some projects supporting payments technology companies, but greater emphasis will be placed on this area going forward.

Key Financial Sector Functions	Capital Allocation	Savings Aggregation	Transaction Processing	Risk Management
Core Institutions	• Banks • Non-Bank Credit • Private Equity Funds • Underwriters	• Banks • Non-Bank Savings • Pensions • Insurance • Asset Managers	• Banks • Exchanges • Clearinghouses • POS/ATM Networks	• Insurance • Credit Bureaus
Additional Institutions / Infrastructure	• Broker-Dealers • Asset Managers • Credit Bureaus	• Broker-Dealers • Investment Advisors	• Merchant Acquiring • Card Processing • Remittance • Loan Servicing • Payroll/HR • Business Processing	• Decision Management • Fraud Detection • Compliance • Title/Appraisal • Collateral Registry • Loan Servicing • Investment Advisors • Market Data

EBRD focus to date:

The EBRD can play a role in supporting financial infrastructure. To date, EBRD has focused mostly on the core institutions involved in capital allocation and savings aggregation. A broader focus across all the key functions of a financial system, to include also transaction processing and risk management, would help to close significant gaps in financial infrastructure, contribute to building new enterprises, support the efficiency of existing clients, and help generate better transition impact. This will be a process that takes time and patience, involving both large and small investment projects, TC and policy dialogue.

6.2.3 Improved corporate governance and business practices

- Project preparation will take into account the ability of partners to develop balanced business models that are based on sound corporate governance and business practices that reduce vulnerability to external events.
  - Experience in the financial crisis has shown that a rules-based approach to regulating and monitoring banks must be supported by qualitative oversight that focuses on sound corporate governance and risk management. Lapses that have come to light have included insufficient

    - Principles of responsible lending will be addressed through the Bank's projects (proper assessment of borrowers and their needs, disclosure of risks and costs, design and introduction of procedures and products for lending to the target group, etc), supported with TC input where necessary.

- Bank projects will seek to promote prudent management of risk and business growth and to support long term stability.

    - Banks that have a strong, independent risk management function with sufficient authority and resources are invariably more robust in the face of economic and market instability. Internal controls are critical to ensuring compliance with procedures and containment of risk. In many of the Bank's countries of operation, particularly in small banks, only rudimentary systems are in place and the Bank will need to engage in a long-term process to assist its clients in moving towards best practice.

- The Bank will work with its clients to identify risk management and corporate governance shortcomings and address them through proactive engagement. Sound projects, accompanied by TC and policy dialogue, will be key to meeting these objectives.

    - The Bank will closely follow developments in international practice, in particular corporate governance principles that are being introduced by the Basel Committee. While policy dialogue and interaction with regulators and other stakeholders will play a role in advancing corporate governance improvements, it will be through securing commitment from shareholders and management in concrete projects that the Bank will be most able to influence the business culture.

6.2.4 Consolidation and privatisation

- Promote and facilitate consolidation, privatisation and re-privatisation of banks.

    - Willing partners are required for consolidation, but the Bank can support and encourage, including through its existing partners.
    - Work with national authorities to re-privatise banks which were nationalised as a consequence of the crisis.

POST-CRISIS FINANCIAL SECTOR CONSOLIDATION
Banking systems remain fragmented in several COO. Despite some consolidation after the crisis of 1998, there are still more than 1000 banks in the Russian Federation and almost 200 in Ukraine. At the top, both systems remain quite concentrated: the top 20 largest banks control around 70% of all banking system assets in both countries, but many of the banks in these countries are quite small. In Russia the 800 smallest banks control only 6% of assets, while in Ukraine the 120 smallest banks account for 8%. While the numbers of banks are smaller in other COO, many would nonetheless benefit from consolidation.

Fragmentation is a potential source of vulnerability in these countries. Banking is a scale business because of the fixed costs of technology, infrastructure, and critical core functions such as risk and treasury management. Small size complicates banks' ability to manage liquidity, especially during crises, and to set up proper risk management functions. Small banks without a clear niche or competitive advantage in a geography or sector are likely to face difficulties with profitability and might engage in excessive risk taking as competitive pressures have risen following the recent liberalization of the financial sectors, the growth of the larger banks' branch networks, and the entry of international banks. Central banks and independent regulators may find it difficult to properly supervise many small financial institutions due to capacity constraints. This could lead to regulatory forbearance, thus weakening overall financial sector stability and hampering economic recovery after the crisis. The central role of confidence in financial sector stability must also be recognised. The failure of small banks is inevitably a blow to confidence and can have systemic implications. Regulators must tread carefully to manage an orderly re-structuring.

The crisis presents an opportunity to further consolidate fragmented banking systems. In the post-crisis period, this process has been largely government-driven. Market-driven consolidation has been hampered by the dearth of capital, lingering uncertainty about the quality of the banks' assets and various regulatory and legal obstacles. On the other hand, bank supervisors have been in a position to withdraw licenses and liquidate various small institutions that became insolvent or whose owners were not in a position to recapitalize them. There are further opportunities for consolidation, however. Failed and nationalized banks could be merged into larger institutions following restructuring of their balance sheets. In the medium term, pre-announced increases of minimum capital requirements, which are still low in a number of countries, could encourage smaller banks to merge.

The EBRD can play a supportive role in the consolidation process. During the pre-crisis period, the Bank supported a number of second and third tier financial institutions under the expectation that their organic growth combined with good governance would ultimately make them attractive to strategic investors. However, the rapid pace of asset growth is unlikely to resume for some time and many international strategic players are focused on stabilizing their core operations, which may limit exit opportunities in some cases. The Bank and its smaller clients will need to consider alternative strategies to generate growth and returns for shareholders, including in-market mergers. The Bank will remain closely engaged with its investees in the coming period and will foster dialogue on possible mergers and acquisitions in countries where consolidation would strengthen the financial system.

CASE STUDY: MDM URSA

EBRD started a relationship with a predecessor to URSA, Sibacadembank (SAB), by providing a loan to the bank under the Russian Small Business Fund (RSBF) programme in early 2003. At that time SAB was ranked 125th by total assets in Russia with 150 points of service in 7 regions and was well positioned to service SMEs and to attract retail deposits.

EBRD became the bank's first foreign shareholder in December 2004, acquiring a blocking minority stake of 25% plus one share. EBRD's investment was conditional on the implementation of an Institution Building Plan (IBP) designed to restructure and strengthen operations of the bank. The management team was strengthened and an internal candidate was appointed as the new CEO. EBRD negotiated a strong shareholders' agreement with three local shareholders, retaining a veto on key decisions. The Bank also nominated a director to the Board of Directors who was very active in promoting good corporate governance practices. In May 2005 SAB became the first Russian regional bank that tapped the Eurobond market, for USD 100 million, highlighting its ability to raise funding on international markets that were not accessible to it before EBRD's investment.

The presence of EBRD was also important in attracting its new investors. In a 2005 capital increase, EBRD increased its total stake to 28% and DEG and Clariden (a private Swiss asset manager which is part of the Credit Suisse Group) joined as two new shareholders with nominees on the Board of Directors. By end-June 2005 SAB was already ranked 77th among Russian banks by capital (103rd at end-2004), 54th by total assets (76th at end-2004). Troika Dialog, a Russian investment bank, also acquired a small stake in SAB via one of its funds in 2006.

EBRD had an important role to play in the merger between Uralvneshtorgbank (UVTB) and SAB that was completed in December 2006 to create the 18th largest bank in Russia. After the merger, SAB was renamed URSA Bank (URSA) and EBRD was diluted to 17.6%. EBRD continued its support by helping the bank to raise its first syndicated loan in 2006, maintained its TFP programme and provided the bank with a credit line for mortgages and a subordinated loan.

The consolidation story was not finished and in 2009 EBRD approved URSA's merger with MDM – the 7th largest private bank in Russia in order to create the second largest privately owned bank in the country. The merged bank will now have truly national coverage of nearly 430 outlets located in over 150 cities, and a strong franchise in both the corporate and retail market segments. EBRD, DEG and IFC (who had been a shareholder in MDM) all supported the merger and remain shareholders of the merged bank. The bank will now serve almost 3 million retail clients and over 30,000 corporate and SME clients, offering an expanded range of financial products.

6.3 Counterparties

Going forward in the strategy period, the Bank will:

- Engage with institutions owned by local shareholders, by foreign shareholders and, in specific circumstances, by the state.
  - Locally owned financial institutions are important clients for EBRD, with a strong commitment to the market in which they work. EBRD can have a very strong transition impact through ongoing engagement as locally owned institutions broaden their activities and improve their business practices and corporate governance.
  - Financial institutions owned by foreign shareholders provide a good platform to improve the quality of financial services and, as demonstrated in the most recent crisis, can be a source of stability. The Bank and its partner banks have benefited from strong relationships built up over time to broaden the availability and diversity of financial instruments.
  - The vast majority of the Bank's financial sector clients are privately owned. State-owned financial institutions, particularly state-owned banks, represent different challenges. In cases where the authorities plan to privatise a bank, EBRD would utilise its experience and good track record and be prepared to engage at a very early stage of the process. In cases where privatisation is not on the agenda, there can be circumstances where commercially-run state banks can be among the few effective platforms for distribution of priority products, such as MSME loans, Energy Efficiency products or TFP. Typically, there would be a strong case for using state-owned banks as conduits to clients that cannot effectively be served by privately owned banks. Examples might include lending to MSMEs in remote or challenging regions or providing trade finance facilities to facilitate trade transactions, particularly when risk aversion among private banks is a concern. These situations would be evaluated on a case-by-case basis and would be reviewed periodically to ensure that the Bank's engagement with the state-owned banks achieves the Bank's goals to

The Bank expects some tension to remain between the objectives of being open to business with a diversified client base and focusing on institutions that are "systemic" by virtue of their size in a particular country, region or market niche. The key determining factor in client selection will be whether a potential client has the capacity – management and financial – to play a significant role in developing the market for financial services. In some countries, smaller but viable banks can be important sources of competition. In countries with fragmented financial systems, engagement with smaller counterparties may be pursued specifically with a view to promoting consolidation.

6.4 IFI Cooperation

The Bank's implementation of its strategy will continue to benefit from enhanced cooperation with other IFIs, building on the experience of the joint crisis response adopted by the EBRD, EIB and the World Bank Group under the Joint IFI Action Plan, with active involvement of the IMF and the European Commission.

During the crisis, the IFIs have demonstrated that they can be effective in coordinating their actions and their communication to clients and to the public. Compared to previous more distant collaboration, this has been a notable step forward in the context of handling the Joint IFI Action Plan in a coordinated and integrated way. Several crisis response transactions were delivered as joint projects among two or three institutions, each bringing their expertise and particular comparative advantage but taking account of the capacities of the other IFIs. Effective cooperation stems from information sharing and shared goals, although not necessarily shared delivery techniques or timetables.

Some examples where IFI cooperation will be an important element in the delivery of the Bank's strategy in the financial sector are noted below:

- Lending to the real economy. IFIs will be called upon to support a post-crisis clean up of banks' balance sheets and the recapitalisation of the sector. Risk sharing instruments will also be instruments that could enhance the willingness of lenders to lend.

- One of the region's sources of vulnerability, foreign exchange lending to un-hedged borrowers, will need to be addressed. This is a clear area where action by a range of IFIs and national authorities will be required to achieve progress over a period of time, combining policy actions, regulatory measures and funding efforts.

- The region needs to reduce excessive reliance on foreign savings and capital. This would require structural reforms to incentivise domestic savings and longer term funding in local currencies. IFIs can play important roles to accelerate this process by providing policy advice, by promoting longer-term local currency

The launch of the Joint IFI Action Plan has been timely and well received by market participants, helping to restore, as an integral part of the massive international crisis response, confidence in the region. As countries start moving toward recovery, it will be essential to continue delivering on the commitments, notably in terms of financial flows to the real economy, and to maintain close collaboration to address the next challenges in a complementary and cooperative manner.

6.5 Cooperation with EU

EBRD has worked closely with the EU and others, with an unprecedented degree of co-operation and joint action aimed notably at reaching a common view on financing needs and macroeconomic scenarios. The European Union extended balance-of-payments assistance to Hungary, Latvia and Romania through the Balance-of-Payments assistance facility for EU countries outside the euro area. The Bank's loans and investments complemented this balance-of-payments assistance.

The European Union has approved, through the EU Neighbourhood Investment Facility, € 12 million to support Institution Building Programmes and EBRD's crisis response activities in Armenia, Azerbaijan, Georgia, Moldova, Ukraine and, on an exceptional basis, in Russia and Belarus. Some of these approved funds have been committed in 2009 and the rest will be committed in 2010 and beyond.

The European Commission has also participated in the Vienna Initiative, an important flanking measure to the Balance-of-Payments assistance facility as well as the EU Neighbourhood Investment Facility.

At the end of 2009 two contribution agreements with the EU in support of EBRD operations in Turkey and the Western Balkans totalling € 42.5 million were also signed. TC and performance fees will provide important underpinning to transition impact over the next 2-3 years in MSME credit lines and energy efficiency credit lines.

These new agreements, together with the finalisation of the Western Balkans Investment Framework have shown the Bank's commitment to the new Brussels based multilateral cooperation structures driven by the EC budget (the Neighbourhood Investment Facility and the forthcoming Central Asia Investment Facility are other examples). Such commitment entails the Bank working more closely with the Commission, the EIB and other participating financial institutions in exchange for co-financing structures that help deliver transition impact.

6.6 Policy dialogue

Policy dialogue will continue to be an integral part of the Bank's approach to the financial sector. The EBRD has established credibility in the sector and has demonstrated over time that its engagement has had positive effects on both the countries and the institutions involved. The Bank's crisis response and the solid performance of most of its partner institutions have strengthened that case.

- The Bank has traditionally been most effective in dealing with project related issues and concerns. Many of EBRD's policy interventions are driven by the need to address obstacles that emerge in concrete projects. Incremental improvements assist the investment environment for other companies in the sector.

- System-wide issues - such as prudential requirements, laws and regulatory issues, consumer protection – are also areas where the Bank's intervention can make a significant difference, depending on the receptiveness of the authorities to the Bank's views. This type of policy dialogue tends to be more top-down in nature, such as assistance in improving insurance sector regulation or developing a framework for deposit insurance, but, if successfully implemented, supports the ultimate objective of delivering Bank projects.

- The Bank can have an important role to play in more macroeconomic spheres, usually from the perspective of an investor in and lender to the private sector and often in conjunction with the European Commission and IFIs, such as the IMF and the World Bank. The Bank's own experience in responding to the crisis demonstrates the value of coordinating with other IFIs and bringing together private and public sector actors to bring about transition impact and institutional change. As an IFI that focuses on the private sector, the EBRD can bring this valuable experience to bear to help formulate a better policy environment for privately owned financial institutions.

Policy dialogue, when combined with investment activity, TC and strong client relationships, can generate and accelerate change. The Bank has the capacity to develop a more strategic approach to institutional quality and reform of financial sectors in the COO, but this approach will need to be based on realistic expectations on the willingness of the authorities to engage and practical objectives based on an in-depth understanding of the operating realities.

One of the key policy dialogue initiatives under the new strategy will be aimed at developing the local currency market infrastructure in selected COO. This will require combining policy dialogue efforts with other IFIs, national regulators, authorities and bank clients, as well as readiness to implement projects in support of the objectives, including local currency lending where practical.

6.7 TC Objectives and Priorities Post Crisis

TC assignments will be designed to facilitate recovery of the financial sector and to further promote financing of the real economy on a competitive and sustainable basis. The types of TC assignments envisaged to be used in the coming period include:

- Institution building programmes
- Portfolio management and NPL workouts
- Credit advisory services and training
- Support for MSME and Energy Efficiency Credit Lines
- Assistance with treasury operations
- Assistance with the local currency lending
- Corporate governance

- Risk management training and advisory services
- Interim management teams
- Assistance with re-privatisation
- Development of local capital markets.

Additional TC will make a considerable difference to programmes and projects aimed at the improvement of the business environment and the development of the financial infrastructure in the COO. These projects would not necessarily be directly related to EBRD investments, but would be important for sustainable transition. In this context, other projects which would be undertaken include:

- Initiatives to improve the regulatory and supervisory approach for financial markets.
- Strengthening the regulatory infrastructure for both life and non-life insurance products.
- Development of financial infrastructure.
- Enhancing the capacity of deposit insurance systems.
- Improving the capacity of payments and settlement systems.
- Responding to specific issues in COO, such as the development of remittance-based products.

TC will continue to be one of the key components, along with policy dialogue and investment projects, for implementing the Bank's strategy. It will be tailored to the priorities of the Bank and the needs of the clients and COO.

7 EQUITY FUNDS

A well functioning private equity industry can play an important part in creating a robust and diversified financial system in the EBRD region and in increasing the range of financial instruments available to corporates to finance their growth strategies across the economic cycle and the stages of the company's development. Most typically, private equity financing is used by companies at the stage when they have not yet reached the size parameters and degree of transparency and sophistication when they could raise equity financing through a public listing (including during the periods when public markets are disrupted), become attractive acquisition target for a strategic buyer, or sometimes even raise bank debt financing. At other times, private equity funds can provide the Bank with a flexible instrument to address a specific market need created by the natural development of the financial markets (e.g. mezzanine funds); government policies (e.g. cleantech funds) or the economic cycle when the companies need to restructure their balance sheets and/or deleverage (e.g. distressed assets funds) etc. The distinguishing characteristic of the private equity model supported by the Bank is the long-term approach and a significant value creation role played by the fund managers in developing the portfolio companies and achieving profitable exits for investors.

Since it started its operations in 1992, the Bank's efforts have been in many ways instrumental in establishing the private equity industry in the region. With the EBRD's support and financing, a significant number of institutional quality fund managers have developed skills, experience and credibility to attract capital and invest it efficiently and profitably in private local companies; and have succeeded in raising follow-on funds. The Bank supported a wide range of funds operating throughout the region and across a variety of sectors, playing the role of the cornerstone investor in many of these funds. Since inception to December 2009, the EBRD has supported 125 funds managed by 79 fund managers. The EBRD is the largest private equity investor in its region with €2.6 billion committed to funds with total capital of €13.2 billion.

Despite the diversity of these funds, there is a common theme of maximising the EBRD impact by significantly leveraging its capital and by injecting operational, managerial and restructuring expertise into building effective local enterprises. The Bank's portfolio has continued to outperform market benchmarks while the specific requirements applied by the EBRD in investing in funds and covering corporate governance, anti-money laundering, integrity and environmental standards and reporting contributed to the overall higher industry standards.

By investing in private equity funds, the Bank aims to achieve the following key strategic objectives: (i) to build private equity institutional capacity in the region; increasing both the depth of industry coverage (from earlier to later stage companies) and its diversification across the geographies and industry sectors; (ii) to increase availability of equity capital in the region, particularly for the small and medium enterprises that otherwise would not be reached by EBRD or other institutional equity investors; (iii) to assist in improving corporate governance standards and practices and in the transfer of managerial and financial skills from fund managers to portfolio companies; and (iv) to assist in the creation of the private equity asset class and in developing a stable international and local investor base for the private equity funds industry in the region. In implementing the strategy the Bank aims to construct a high quality balanced and diversified portfolio of "best in class" funds capable of performing well against industry benchmarks and thus capable of achieving a strong demonstration effect.

7.1 Crisis Impact and Remaining Transition Challenges

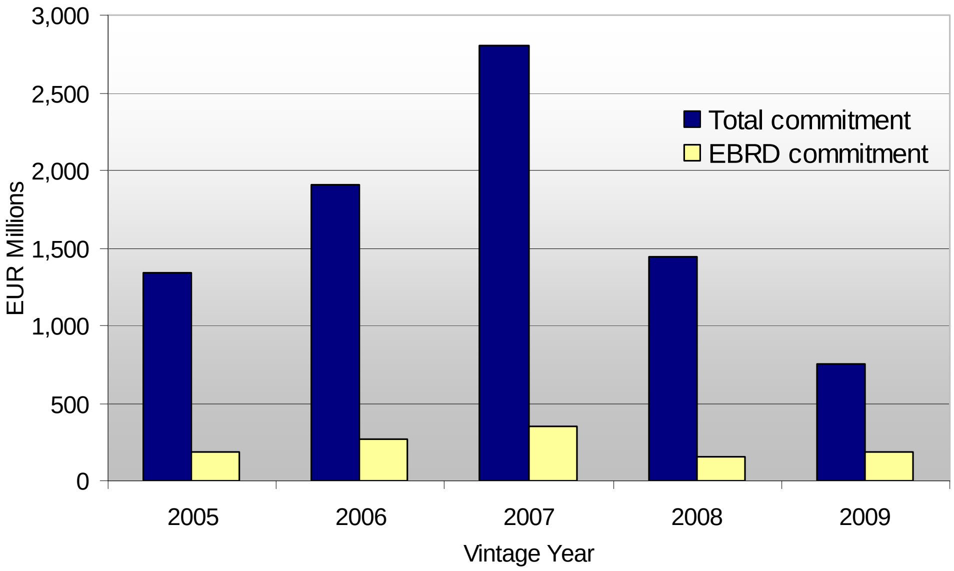
The 2009 Assessment of Transition Challenges **(**ATC) notes that private equity[2] remains one of the areas where transition challenges are greatest, with 26 countries facing medium and large sized challenges. Overall there are still significant gaps in both the institutional management capacity and sector expertise among the fund managers operating in the region. Private equity in the region has yet to become a mature asset class with a fully developed and dedicated investor base, while portfolio allocations to private equity in the EBRD region among western institutional investors remain highly volatile. Among the principal impediments to the greater maturity of the industry are the lack of local management expertise (especially in certain geographies and sectors), existing restrictions on pension funds allocations in certain countries, lack of strong domestic financial and industrial groups and, in some instances, the early stage of development of local capital markets. Participation of local institutional investors remains extremely limited in the region.

[2] The 2009 ATC groups private equity together with bond and equity market development.

Fundraising

According to EMPEA[3], fundraising for private equity funds dedicated to emerging markets slowed dramatically in 2009; with total fundraising for CEE and CIS falling 70 %[4].

Exhibit 1: Fund raising vs. EBRD Commitments, 2005-2009



Data on the EBRD-tracked portfolio over the past five years further demonstrates the significant drop in fund raising figures beyond the peak year of 2007. Institutional investors were less able to support new funds, and cumulative commitments lost 48 % of the peak 2007 value. The EBRD's commitments decreased by over 57 % in 2008 as compared to the previous year, but were maintained in 2009 at a level similar to 2008 of €187 million, as EBRD stepped up its support to the private equity industry amidst an extremely difficult fundraising environment. Ramifications of the financial and economic uncertainty continued to inhibit overall fundraising, which left 2009 with the lowest volume of overall commitments to CSE/CIS private equity for the last five years.

Industry capacity in the region going forward has been impaired as a result of the economic crisis, which resulted in the fundraising environment becoming extremely challenging even for experienced teams and especially so for the "first time" funds (i.e. where the management team has not previously managed a private equity fund or

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[3] Emerging Markets Private Equity Association (EMPEA) is a non-profit independent, global industry association that promotes greater understanding of and a more favourable climate for private equity and venture capital investing in the emerging market of Africa, Europe, Latin America and the Middle East.
[4] EBRD commitments in the first half of 2009 were 24.75 % of their level in the first half of 2007, whereas commitments by all investors stood at 11.6 % for the same period. This demonstrates EBRD's continued support to this industry in time of crisis. Comparing first half of 2009 to the second half of 2008 shows a decline of 31 % in EBRD commitments, and 37 % decrease for overall commitments (for EBRD-tracked portfolio).

where a management team is raising a new fund with a different investment strategy and focus). This difficult fundraising environment has resulted in the need for more significant commitments from the Bank and other IFIs and development institutions: in 2009 the share of IFIs and governments in commitments to private equity funds rose to 56.3%[5] from 16% in 2008 (versus an average of 28.5 % in 1992-2007). These challenges are likely to persist in the short to medium term and will continue to require increased counter-cyclical commitments from the Bank.

Depth and diversification

Diversification of private equity product offering remains low in the region: the examples of mezzanine financing, special situations funds, secondary funds remain scarce. The venture capital industry, including cleantech, remains under-developed throughout the region. Several important government-led programmes have been announced that aim at fostering innovations and facilitating growth of start-ups and early stage firms, however the critical constraints remain the limited availability of management teams with the requisite set of qualifications and track record to manage what are highly specialized and high risk funds and the resulting absence of a significant risk appetite for this asset class in the region among institutional investors.

Developed countries with well functioning capital markets have seen the penetration level of institutional private equity investment of 0.5-1.4 % of GDP on average over the past several years, while in the EBRD region these numbers have so far remained considerably lower even among the countries with more advanced financial systems. In Poland the volume of institutional private equity investment averaged 0.19% of GDP over the 2006-2008, while in Russia this measure stood at 0.12%[6]. The long-term expectation for the private equity in the region is for the industry to evolve to the level of mature markets in terms of penetration and product diversification offering, while attracting a wider pool of local investors.

7.2 Operational Priorities

The Bank will continue to promote the private equity industry across the region aiming to address an important gap in the availability of both equity financing and management and financial expertise. In doing so the Bank will selectively support fund managers able to create value by engaging directly and on an ongoing basis with investee companies; and will aim to maintain a balanced well-diversified funds portfolio providing performance benchmarks for the region. The strategic objectives will be translated into the following key operational priorities for the Bank in working with funds:

- Making equity financing available to companies which the Bank would not reach otherwise, focusing on small and medium sized companies (including "mittelstand" segment).
- In building the institutional capacity of the industry and advancing the establishment of a private equity in the region, the Bank will continue:

[5] Based on preliminary 2009 data
[6] For comparison UK recorded a penetration rate of 1.23 % over the same period, while overall in Europe the rate averaged at 0.51 % based on European Venture Capital Association data.

- Supporting both first time and successor funds which can demonstrate strong management team potential. The Bank will selectively take a higher degree of risk (in terms of percentage stake in the capital of the funds, particularly in the first closings) in promoting and developing first time fund managers, until such time as their investor base can be diversified.
- Playing a leading role in building private equity activities in ETCs as well as in under-penetrated markets such as SEE, Caucasus, Central Asia, in the same way EBRD played a key role in the creation of private equity industry in Central Europe and Russia. In Turkey, the Bank will continue to work in forming strategic alliances in preparation for the Bank's increased business volume in the future. Striking the right balance between achieving diversification and being an active and influential limited partner in Turkey focused funds will be crucial.
- While the case for donor supported funds still remains, the Bank would provide the bulk of the capital through appropriate intermediaries to address the capital needs of smaller businesses (especially in regional areas in COO), and to provide more intense and local post-investment support for investee companies and fund managers. Targeted TC support could also be considered to support first time fund managers and specific development projects at portfolio companies (i.e. implementing best practice corporate governance, improving legal and financial transparency etc).

- While maintaining the core focus in the portfolio on the "generalist" private equity funds, the Bank will aim to underpin the development of the industry capacity through diversification and innovation, in particular:
  - Selectively supporting highly skilled local and international management teams in cleantech, renewable energy and energy-efficiency sectors.
  - Fostering local innovation and technological development in the region by supporting "best in class" local and international sponsors in specialist technology focused venture capital and private equity fund managers.
  - Continuing to facilitate the development of innovative financing tools through the support of selected niche funds offering more specialised products, such as mezzanine capital, infrastructure and sector-specific funds.
  - As part of dealing with the legacy of the crisis, supporting on a case-by-case basis "best in class" funds focused on turnaround / distressed situations and enterprise restructuring with fund managers who have the appropriate local presence and hands-on restructuring expertise, and support existing funds affected by limited partners who default on their obligations by providing additional investment.
- Stepping up the efforts to attract institutional investors and government agencies to invest in private equity in the region, the Bank will be:
  - Selectively upholding the initiatives aimed at encouraging local pension funds to invest into private equity asset class, including by sharing its extensive in-house experience with fund managers and institutional investors.
  - Continuing to cooperate with other IFIs and development institutions (including government agencies) in supporting the development of venture

- Participating in the initiatives aimed at increasing the transparency, visibility and attractiveness of the private equity industries in its COO for domestic and international investors, including through cooperating, in an appropriate format, with local and international industry associations and organisations.

In implementing the strategy the Bank will continue to encourage fund managers to use the Bank's Co-Investment Facility (equity, quasi-equity and mezzanine) and will seek to improve the efficiency of sharing and processing the co-financing opportunities among various teams in the Bank.

ANNEX 1 – Assessment of Transition Challenges 2009: Financial Institutions

Assessment of Transition Challenges 2009: Financial Institutions

	Banking	NBFI	MSME	PE&Cap
Central Europe and Baltics	**2.13**	**2.13**	**2.88**	**2.75**
Croatia	2	2	3	3
Estonia	2	2	3	3
Hungary	2	2	3	2
Latvia	3	2	3	3
Lithuania	2	2	3	3
Poland	2	2	3	2
Slovak Republic	2	2	2	3
Slovenia	2	3	3	3
South Eastern Europe	**2.86**	**3.00**	**3.00**	**3.57**
Albania	3	4	3	4
Bosnia and Herzegovina	3	3	3	4
Bulgaria	2	2	3	3
FYR Macedonia	3	3	3	4
Montenegro	3	4	3	4
Romania	3	2	3	3
Serbia	3	3	3	3
Turkey	**3**	**3**	**3**	**2**
Eastern Europe and Caucasus	**3.50**	**3.83**	**3.50**	**4.00**
Armenia	3	4	3	4
Azerbaijan	4	4	4	4
Belarus	4	4	4	4
Georgia	3	4	3	4
Moldova	4	4	3	4
Ukraine	3	3	4	4
Russia	**3**	**3**	**4**	**3**
Central Asia	**3.83**	**3.83**	**4.00**	**3.83**
Kazakhstan	3	3	4	3
Kyrgyz Republic	4	4	4	4
Mongolia	4	4	4	4
Tajikistan	4	4	4	4
Turkmenistan	4	4	4	4
Uzbekistan	4	4	4	4
EBRD region	**3.11**	**3.21**	**3.43**	**3.54**

Legend: 1=negligible challenges, 2=small challenges, 3=medium challenges and 4=large challenges.

ANNEX 2 – Summary of results of the Evaluation Department study

This strategy document incorporates many of the recommendations made by the EVD Special Study on the Financial Sector Operations Policy (2007). Other recommendations have been implemented as a matter of ongoing business and operation implementation.

The EvD study recommended refocusing priorities to target remaining transition challenges, with strong linkages between those priorities and investment climate initiatives, and strong linkages between policy dialogue and project objectives.

The key recommendations made by the study were:

- **Clearly focused policy priorities**

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

- **Political support for financial sector reforms**

Countries must build the technical capacity for financial sector regulation and supervision.

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

Design investment operations in such a way as to stimulate and encourage the development of sound legal, regulatory and supervisory frameworks in countries where these are still lacking.

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

Seek to coordinate investment operations as closely as possible with initiatives to develop market supporting institutions and policies.

- **Coordination with other IFIs**

Establish a strategic approach to the Bank's cooperation with other IFIs that involves formal and regular consultations in order to reach common ground on approaches to overcome resistance to privatisation, develop sound prudential supervision and improve governance.

- **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.

- **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.

- **Estimating financial returns from operations**

Project selection should weigh projected return against transition and market pricing considerations, particularly in earlier transition countries.

The study noted that the Bank should make a more concerted effort to promote investment project objectives that reinforce market supporting institutions and policies. This will entail increased policy dialogue, increased interaction with the authorities, increased TC that may be only indirectly project related, and increased investment in financial infrastructure. These recommendations are particularly relevant in the context of crisis response in cooperation with strategic shareholders, home and host authorities and other IFIs, and will continue to be relevant as the strategy outlined in this report is implemented.

ANNEX 3 – Development of Local Currency Bond Markets in East Asia

Since the Asian financial crisis in 1997-98, local currency bond markets in emerging East Asia[1] have shown strong growth. The total outstanding amount of local currency bonds in East Asia (excluding Japan) increased from USD 0.5 trillion at end 1996 to USD 4.4 trillion at end 2009. Local currency bonds in emerging East Asia now account for 6% of global bond markets. This rapid development reflects a high priority given by policymakers in East Asia to develop local currency bond markets. The development of well functioning local currency bond markets has been seen as a way to avoid the "double mismatches" of maturity and currency that exacerbated the financial crisis in East-Asia and to recycle huge East Asian savings without having to channel through financial markets of advanced countries.

The development of bond markets has been pursued by East Asian countries through regional collaboration initiatives. There are two major initiatives for bond market development in the region: the Asian Bond Markets Initiative, and Asian Bond Funds Initiative, as described below.

Asian Bond Markets Initiative (ABMI)

The ABMI was agreed at the ASEAN+3 Finance Ministers' Meeting[2] held in August 2003 in Manila. The aim of the ABMI is to develop efficient and liquid bond markets in Asia, in order to promote increased circulation of Asian investments within the region. Since its launch, ABMI contributed to the development of local bond markets by providing the forum to the member countries for policy coordination and regulatory harmonization, market infrastructure improvement, new product development and information dissemination

Given the complexity of the issues and the varying levels of bond market development in ASEAN+3 countries, six voluntary ABMI Working Groups were initially formed by member countries to address the following six areas: (i) New Securitised Debt Instruments, (ii) Credit Guarantee and Investment Mechanisms, (iii) Foreign Exchange Transactions and Settlement Issues, (iv) Issuance of Bonds denominated in Local Currency by MDBs, (v) Rating Systems and Information Dissemination on Asian Bond Markets, and (vi) Technical Assistance Coordination. The Asian Development Bank has been closely involved in ABMI by (i) providing technical support to the Working Groups, (ii) launching the Asian Bonds Online Website and Asian Bond Monitor, (iii) setting up the Asian Currency Note Programme to set up a unified platform for regional and international issuers to tap regional markets, and (v) issuing bonds in local markets.

Following the success of the initial phase of ABMI, the ASEAN+3 Finance Minister's meeting in May 2008 agreed on a more comprehensive medium-term road map to accelerate the development of the local currency bond markets. The new ABMI road map focused on four key areas: (i) **Promoting Issuance of Local Currency-Denominated Bonds (supply side)** through development of credit guarantee mechanism, an Asian Currency Note Programme, structured finance instruments and strengthening derivative and swap markets as well as local underwriters, (ii) **Facilitating the Demand for Local Currency-Denominated Bonds (demand-side)** through improvement of the investment environment for institutional and retail investors, development of repo and securities borrowing and lending markets, facilitating cross-border transactions through enabling tax, capital and forex regulations, and

[1] Emerging East Asia in the statistics comprises the People's Republic of China; Hong Kong' China; Indonesia: Republic of Korea; Malaysia; Philippines; Singapore; Thailand; and Viet Nam.

[2] ASEAN+3 includes 10 ASEAN countries (Brunei, Cambodia, Indonesia, Lao PDR, Malaysia, Myanmar, Philippines, Singapore, Thailand Vietnam) and 3 non-ASEAN countries (China, Japan and Korea)

information dissemination (iii) **Improving Regulatory Frameworks** through strengthening regulatory and supervisory frameworks for bond markets, facilitating collaboration among securities dealers associations and self-regulatory organizations, improving bankruptcy procedures related to bond transactions and improving accounting and auditing standards, and (v) **Improving the Related Infrastructure for the Bond Markets** through strengthening settlement infrastructure including regional settlement systems, increasing bond market liquidity, fostering credit culture and developing professional services. The Working Groups were reorganised into four Task Force Group responsible for the above four areas whose progress is monitored and coordinated by the ABMI Steering Group reporting to the ASEAN+3 Finance Minister's meeting.

In line with the new medium-term road map, the ASEAN+3 Finance Ministers' Meeting in May 2009 endorsed the establishment of the Credit Guarantee and Investment Mechanism (CGIM) in 2010 as a trust fund of the ADB with an initial capital of USD 500 million to support the issuance of local currency-denominated corporate bonds in the region. The formation of a set of "bond market development indicator" was also agreed in the Ministers' meeting in April 2010 as a scorecard to identify key priorities for bond market integration and development in the region. Substantial progress has also been achieved in the creation of "ASEAN and Plus Standards" for multi-jurisdictional offerings of securities and promotion of dual listing of securities and cross-border offerings of debt securities and collective investment schemes.

Asian Bond Funds Initiative (ABF)

ABF project is a regional initiative by the Executives' Meeting of East Asia Pacific Central Banks (EMEAP)[3] which aims to function as a catalyst for developing markets in the East Asia and Pacific region by focusing on developing the demand side. The objectives of ABF are to (i) act as lead investor and thus serve as a catalyst to attract private investors and boost investment in Asian issues, and (ii) diversify investment in foreign currency denominated assets held at central banks and monetary authorities away from US/ European securities and into Asian bonds.

On 2 June 2003, the EMEAP announced the launch of the first Asian Bond Fund (ABF1), which initially amounted to approximately USD1 billion from international reserves pooled from the EMEAP central banks. The ABF1 invested in a basket of US dollar-denominated bonds issued by sovereign and quasi-sovereign Asian issuers in EMEAP economies (other than Japan, Australia, and New Zealand). The Bank for International Settlements manages the ABF1 in a passive style in accordance with a specific benchmark.

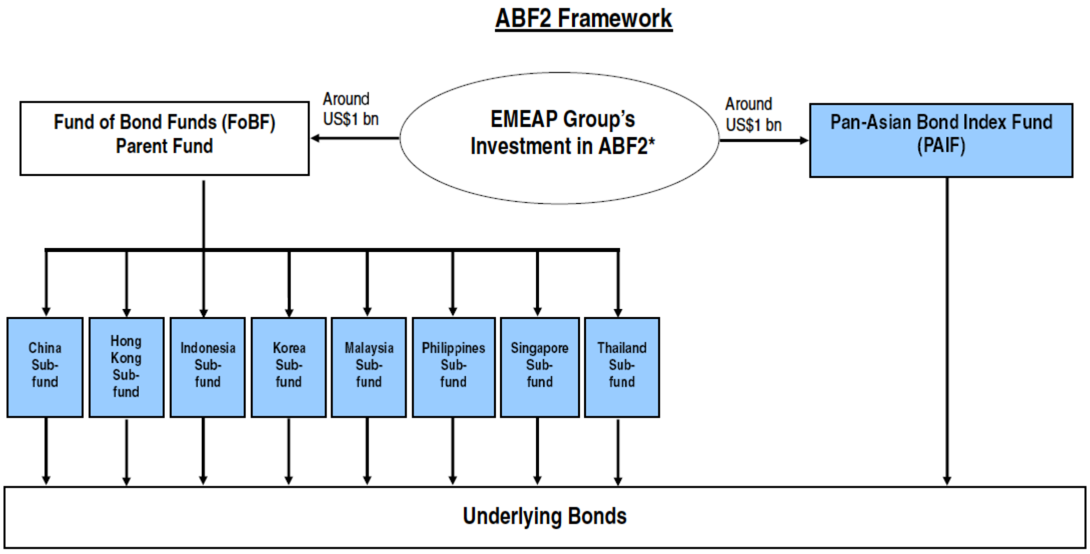
The ABF initiative entered into its second stage with the launching of the Asian Bond Fund 2 (ABF2) in December 2004. ABF2 invests in local currency bonds issued by sovereign and quasi-sovereign issuers in EMEAP economies (other than Japan, Australia, and New Zealand). It consists of two components, a Pan-Asian Bond Index Fund (PAIF) and a Fund of Bond Funds (FoBF). PAIF is a single bond fund index investing in sovereign and quasi-sovereign local currency bonds issued in eight EMEAP economies. FoBF is a two-tiered structure with a parent fund investing in eight Single-market Funds, each of which will invest in local currency sovereign and quasi-sovereign bonds issued in their respective markets.

PAIF and the eight Single-market Funds are passively managed by private fund managers against benchmark indexes called the iBoxx ABF Index Family. In the initial phase of ABF2,

[3] The eleven members of the EMEAP include the Reserve Bank of Australia, the People's Bank of China, the Hong Kong Monetary Authority, Bank Indonesia, the Bank of Japan, the Bank of Korea, Bank Negara Malaysia, the Reserve Bank of New Zealand, Bangko Sentral Ng Pillipinas, the Monetary Authority of Singapore, and the Bank of Thailand.

investment was funded solely by international reserves pooled from the EMEAP central banks. USD1 billion was allocated to PAIF and another USD1 billion was allocated to the eight Single-market Funds. In the second phase of ABF2, these nine ABF2 funds have been gradually opened up to other institutional and retail investors, both within and outside the EMWAP region. PAIF is listed in Hong Kong Stock Exchange as a bond ETF and cross-listed in Tokyo Stock Exchange. The eight single market Funds are also to be listed in the respective country's exchange and with the listing of Chinese fund planned in 2010, this task will be completed.

Framework of Asian Bond Fund 2



Source: Review of the Asian Bond Fund 2 Initiative (June 2006), EMEAP.

ABF initiatives successfully introduced a new asset class with cost competitiveness and low entry threshold for investors interested in local currency bonds markets in region. It has also facilitated bond market development by identifying impediments and acting as a catalyst for regulatory and tax reforms as well as improvement of market infrastructure. As the initial goals of the ABF initiative have already been nearly completed, the member countries are currently considering their next steps including possible exit of public funds from the ABF2.

Current Crisis and Local Currency Bond Markets in Asia

Long-term regional efforts under the above initiatives to develop local currency bond markets have successfully paid off when the current global financial crisis hit the region. Local currency bond markets have shown their resilience during the current crisis and emerged as a key source of funding regional governments looking to raise funds to finance rising fiscal deficits and for corporates seeking new funds and for refinancing as banks continued to limit their lending. Banks in the region also turned to local currency bond markets to build their capital with subordinated debt. With a sharp 39.3% increase in new issuances, the total outstanding amount of local currency bond markets in emerging East Asia expanded 16.5% in 2009 to reach USD 4.4 trillion at end 2009. In particular the corporate bond market grew 31.6% in 2009 compared to an 11.2% increase in the government bond markets.

ANNEX 4 - Equity Funds: Regional snapshot

The information shown below provides a regional snapshot of the private equity sector development.

South-Eastern Europe

Private equity remains in its early stage, and the region has yet to attract substantial interest from international private equity funds due to the small and fragmented nature of the markets. The majority of SEE regional private equity funding is sourced from non-domestic investors. While over 40 EBRD-sponsored regional funds have made investments in SEE countries since inception, Romania and Bulgaria account for the bulk of the private equity activity in the region, with only 9 funds having invested in other countries of the region since inception to end 2009. The penetration of private equity remains generally very low, and an occasional large transaction is capable of significantly distorting the overall statistics. The penetration levels vary throughout the region from almost non-existent to 0.2-0.3% of GDP in Bulgaria and Romania.

Eastern Europe and the Caucasus

A viable private equity industry is only gradually developing in Ukraine while the overall number of participants remaining very low – no more than 10 funds have active operations in the country. Together with the Baltic States, the Ukrainian economy has been among the hardest affected by the financial turmoil. Private equity penetration as measured by fund investments to GDP rose over the past several years from virtually zero to 0.25 % in 2008. There are currently only three active EBRD-supported funds dedicated to Ukraine managed by two management groups.

In the five other countries of this region local private equity remains absent or underdeveloped with only very limited interest from international private equity funds and irregular investments from regional CIS-focused funds. As of end 2009, EBRD-backed funds made one investment in Azerbaijan, two in both Georgia and Moldova, while no investments have been made in either Armenia or Belarus.

Central Asia and Mongolia

The Kazakh private equity industry remains underdeveloped and is represented by a very small number of participants and depends on support from the government and development institutions. Mongolia is a frontier market, which so far has not attracted the attention of private equity funds, however the country's potential is beginning to attract interest from private equity managers. The less advanced transition countries in the Central Asia region remain on the periphery of global financial markets and show predominantly large transition gaps across the financial sector including equity funds. There are currently only two active EBRD-sponsored funds dedicated to the region, focusing primarily on Kazakhstan.

Russian Federation

The private equity sector has shown dynamic development in the years prior to the financial crisis, driven in particular by improving exit options due to availability of liquidity among financial and strategic buyers; however the industry was severely affected by the financial crisis. The number of institutional quality private equity funds remains very low, particularly with reference to the size of the economy, with very few international participants present. While a small number of larger funds were raised before the onset of the financial crisis, the fundraising environment has severely deteriorated and is likely to remain very challenging in the medium term. The industry still lacks depth and diversification; while local institutional investors remain largely absent. Since inception to end 2009, the EBRD has supported 27 Russia focused funds of which 15 are currently active. Private equity penetration remained low at 0.15% in 2008[4].

Central Europe and the Baltics

The private equity industry is relatively developed and provides an important source of capital and managerial skills in most parts of this sub-region. Out of all countries in the region and overall in the EBRD COO, Poland has the most developed private equity sector with a significant number of experienced managers. The industry development has been assisted by the Warsaw stock exchange providing viable exit opportunities for the private equity funds. Private equity penetration in Poland rose from 0.05 % in 2005 to 0.17 % in 2008, while Hungary recorded a significant increase from 0.163 % to 0.42% of GDP over the same period.

Across the Baltic States, the EBRD to date has worked with 15 funds, however the number of active funds remains very low and the impact of the financial crisis on the industry has been the greatest; while the institutional investor appetite has evaporated in the short term and the capacity of the industry has been drastically reduced. Penetration of private equity in the Baltic States trended up to 0.36 % in 2008, however this level is unlikely to be sustained in the short to medium term.

Turkey

Despite a significant number of international private equity houses targeting the country, private equity penetration in Turkey is still comparatively low with only a few dedicated funds. There is capital scarcity for lower and mid-market companies in Turkey where bank borrowing and access to public equity markets are still either limited or challenging, constraining the growth potential of many promising companies.

Two important private equity players in Turkey were established in 2000 – Turkven Private Equity and Turkish Technology Foundation. Private equity activity slowed sharply after the establishment of these two funds, primarily due to the bursting of internet and telecom bubbles in the US, followed by 9/11 and the major crisis in Turkey. Major funds and investment houses that had been considering the market, refocused to Western markets. Private equity activity started to increase between 2003-2005, as the EU accession negotiations became a possibility. As of the end of 2008, there were 30 private equity funds operating in Turkey, bringing private equity penetration to 0.29% of GDP. Although Turkey is weathering the recent financial crisis relatively well, the overall drop in global fund raising means that IFI endorsement particularly at the first close of a fund is almost a must.

[4] Source: EM PE Industry Statistics: Fundraising, Investment, Performance, EMPEA publication (March 2010).