DOCUMENT OF THE EUROPEAN BANK
FOR RECONSTRUCTION AND DEVELOPMENT

FINANCIAL SECTOR OPERATIONS POLICY

Approved by the Board of Directors
6/7 July 1999

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PRESIDENT'S RECOMMENDATION

A well functioning market economy requires a sound and effective financial sector that commands the confidence of the population, facilitates monetary transactions, and intermediates effectively between savers and investors. The Bank's countries of operations started transition with financial sectors that possessed none of these characteristics. The financial sector has thus been a priority for the Bank since its inception, with the Bank's **Articles of Agreement** placing special emphasis on the financial sector (Article 2).

In the recent assessment of the Bank's operational priorities, "**Moving Transition Forward: Operational Priorities for the Medium Term**" (BDS99-24 (Rev 1)), the strong focus on the financial sector was reaffirmed. The refocused operational priorities commit the Bank "to develop a strategic view of the challenges facing the financial sector in each country, paying special attention to competition, decentralisation and variety in the provision of services". They also commit the Bank "to continue to help build the necessary financial institutions by investing in them, by transferring skills and by requiring sound business practices. It will work with a broad range of instruments and promote both bank and non-bank financial institutions and the development of capital markets. Based on its investor experience and working with the other IFIs and national authorities, the Bank will also promote sector reform, in particular sound regulation and effective supervision".

This paper reviews and refocuses the Bank's **Financial Sector Operations Policy**, reflecting both developments in the operational environment and the Bank's experience with its financial sector operations. The refocused operational policy takes a more **systemic** view, with particular emphasis on how the Bank's operations affect the development of the financial system as a whole. The approach also recognises that the financial sectors in each country possess a different mix of financial institutions and financial instruments, reflecting their particular histories and tradition. A key element of the refocused operational policy is thus the development of **country-specific operational approaches**.

The operational policy also recognises that confidence and competition in an independent financial sector are fundamental factors that shape development of the financial sector in a market economy. While the demand for payment services and financial intermediation arise from the economic and financial activity, business and households must have confidence in financial institutions and markets for these demands to be placed on the local financial sector. This **confidence** requires an appropriate institutional framework, consisting of adequate and effective laws, regulations and business services. The supply response to the demands comes from **competition** and initiative in an independent financial sector focused on serving its customers.

The Bank's objectives for financial sector operations are to strengthen the mechanisms of financial sector development through its investment **projects** and **investment climate** initiatives. The refocused policy aims to integrate the project-level impacts of building institutions and increasing intermediation, key objectives of the existing operational policy, into an overall vision of how the financial sectors should function and develop.

Specifically, the Bank will seek to invest in financial sector **projects** that possess some of the following characteristics:

- increase the **diversity of institutions** and the range of financial instruments in the local financial sector, including **specialised institutions**;
- extend the coverage of the financial sector to **new types of customers**, particularly in the private sector and **small and medium-sized enterprises** (see also "Promoting SMEs in the Transition: A Strategic Approach");
- broaden the **geographical coverage** of the financial sector, particularly to **regions** in which a cluster of Bank operations can reinforce progress in reform;
- strengthen the **corporate governance and business practices** of local financial institutions;
- facilitate **foreign direct investment** into local financial sectors to strengthen private ownership and corporate governance, demonstrate sound business practices and to transfer capital and skills;
- facilitate **mergers within the region** where appropriate, supporting the expansion of those local institutions that have performed well;
- strengthen the **commercial orientation of state-owned financial institutions**; and
- support **privatisation** of state-owned financial institutions.

The appropriate mix of project characteristics will depend on the specific conditions in each country of operation. In project design and implementation, particular emphasis will be placed on the **mitigation of systemic risk**, **intensified portfolio monitoring** and management and a strengthened **corporate governance** role for the Bank, in response to the Bank's investment experience.

A well functioning financial sector, however, does not mean a hands-off role for government. **Government must take a strong but limited role** to promote confidence, competition and the right kind of investment climate in the financial sector. It is important to recognise that attractiveness of the local financial sector to investors depends on its institutional foundations and structure. Crucially, local banks must command the confidence of depositors. The system must also be competitive, including suitability tests for new entrants and fair and transparent mechanism for the restructuring or liquidation of insolvent institutions. Effective competition also requires that the financial sector is neither subject to arbitrary government influence nor captive of business interests.

To implement the refocused financial sector operations policy, the Bank will develop a **financial sector approach for each country.** This approach will be based on assessments of: the business environment in the country; the main risks to macroeconomic stability; the key challenges facing the financial sector in the country; the market mechanisms and financial institutions that will drive financial sector development in the country; the strengths and weaknesses of the legal, regulatory and supervisory framework; and how the Bank's investment projects and other activities can best influence the process of financial sector development.

I recommend this document for approval by the Board.

Horst Köhler

I FINANCIAL SECTORS IN THE BANK'S COUNTRIES OF OPERATIONS

1.1 DEFINITION OF THE SECTOR

The demand for financial services by households and business, as well as by governments, can be fulfilled through a wide variety of financial markets and institutions. This **range of activity** reflects the diverse requirements of savers for liquidity, risk and return and the alternative ways in which investment opportunities are evaluated and actual investments are monitored. The mix of financial institutions and financial instruments varies widely across countries, reflecting different historical developments and traditions.

1.1.1 Banks and Money Markets

The foundation of a financial sector is the banking system and the money market. Banks provide **basic transactions services** by issuing and transferring liquid deposits. These services facilitate not only economic transactions in the real economy, but also other types of financial activity. For banks to provide transactions services there must, in turn, be a market for liquid assets with a certain value that banks can exchange to settle transactions. The markets for inter-bank deposits and for treasury bills are typically the source of this liquidity.

Banks also **mobilise savings** through term deposits and **allocate these resources for investment** through lending activities. But there are substantial differences among banks and the type of customers on which they focus. While universal banks seek to reach a broad customer base with a wide range of products, other types of banks specialise on particular types of customers and products, such as savings banks, commercial banks and micro-finance banks. Specialisation among banks reflects alternative ways of reaching customers and of meeting their particular demands for banking services.

1.1.2 Non-bank Financial Institutions

While banks are characterised primarily by their deposit and loan products, non-bank financial institutions undertake a **range of specialised activities**. Leasing companies provide an alternative to secured bank loans for the funding of fixed investment. Institutions such as life insurance companies and pension funds offer contractual saving instruments to households and invest in long-term debt, commercial real estate and equity. Institutions such as unit trusts and mutual funds enable retail investors to invest collectively in portfolios of marketable securities. Yet other institutions, such as private equity funds and venture capital funds, provide sophisticated investors with the opportunity to invest in portfolios of non-marketable securities.

1.1.3 Securities Markets

Public securities are the marketable obligations of government and of corporations. The market for government debt is usually the first securities market to develop in a country, because of the relatively lower risk of government obligations and the relatively high transparency of public finances compared with those of private corporations. A public market for corporate equities and bonds requires **extensive supporting institutions**, including acceptable accounting rules, professional auditors, extensive financial disclosure, and effective governance practices. The market for private equity and debt relies less on these institutions and more on long-term relationships between investors and borrowers. However, these securities typically lack the liquidity of public debt and equity.

1.2 ROLES AND REQUIREMENTS OF THE SECTOR

The basic roles of the financial sector are is to provide the **monetary payment** and **intermediation** services demanded by households and businesses, as well as by government. Customer demands arise from the economic and financial activities that they undertake, but they must have confidence in financial institutions and markets for these demands to be placed on the local financial sector. This confidence requires an appropriate institutional framework, consisting of adequate and effective laws, regulations and business services. The supply response to the demands comes from competition and initiative in a financial sector focused on serving its customers. Taken together, these factors – confidence and competition in an independent financial sector – shape the development of the financial sector in a market economy.

Governments must play a strong but limited role in promoting confidence in the financial sector. This confidence must ultimately derive from the quality of assets that financial institutions hold and from the transparency and fairness of financial markets. High quality financial assets require a **stable macroeconomic environment** and an appropriate institutional framework for banks, non-bank financial institutions and securities activities. Providing this environment is a central responsibility of government.

Prudential regulations aim to provide banks with a strong incentive for prudence in the form of capital adequacy requirements. Adequate capital, combined with effective ownership and corporate governance of banks, can serve to install a culture of sound banking practices. Prudential regulations also serve to constrain bank risk taking through restrictions on concentrated exposures, connected lending, maturity mismatches and foreign exchange exposures. Effective enforcement of prudential regulations requires internationally acceptable accounting standards for banks and independent audits, as well as supervision by the regulator. The soundness of banks also depends crucially on the specification and enforcement of creditor rights (arrangements for secured lending and effective bankruptcy proceedings) and on the accounting and auditing practices in the corporate sector. Confidence of depositors is further strengthened by the seniority of their claim to bank assets and freedom from administrative seizure without due process. The property rights of depositors must be enforced fairly and transparently.

A **deposit insurance** scheme for retail depositors can further enhance depositor confidence. However, an effective framework for prudential regulation and supervision must precede implementation of deposit insurance, if the fiscal costs of the scheme are to be effectively managed.

Prudential regulation of **non-bank financial institutions**, as of banks, serves both to create a strong incentive for prudence (through capital requirements and fiduciary liability) and through restrictions aimed at curbing excessive risks (permissible assets held by private pension funds). Confidence in **securities markets** arises in part from **transparency** of trades (both prices and volumes) and of corporate finances. It also requires effective prohibitions on market abuses such as insider trading by corporate managers and front-running customer trades by market makers.

Competition among financial institutions serves to strengthen their focus on serving the needs of their customers, particularly businesses and households. Keys to effective competition in the financial sector are **decentralisation and diversity** in the provision of financial services. Within the financial sector, there should be scope for a range of national, regional and specialised banks, for non-bank financial institutions and for securities markets. There must also be appropriate criteria for entry into the sector, including minimum capital requirements and suitability tests for entrants. Equally important, there must be an appropriate process for exit for troubled institutions, with effective and fair procedures for identifying insolvent institutions and resolving their difficulties through restructuring or liquidation.

Effective competition, however, is not sufficient to ensure efficient intermediation. There must also be **independence from political interference** in making operating decisions. Experience has shown that state-owned financial institutions are more susceptible to political interference in their decision process and are more likely to be bailed-out when their investments sour than are private institutions. However, sound corporate governance and effective curbs on conflicts of interest must accompany **private ownership** if private financial institutions are to perform well. Experience has shown, for example, that ownership of banks by industrial firms can encourage concentrated and connected lending exposures. A successful transition requires that there be neither directed credits nor connected lending.

1.3 State of Development of the Financial Sector

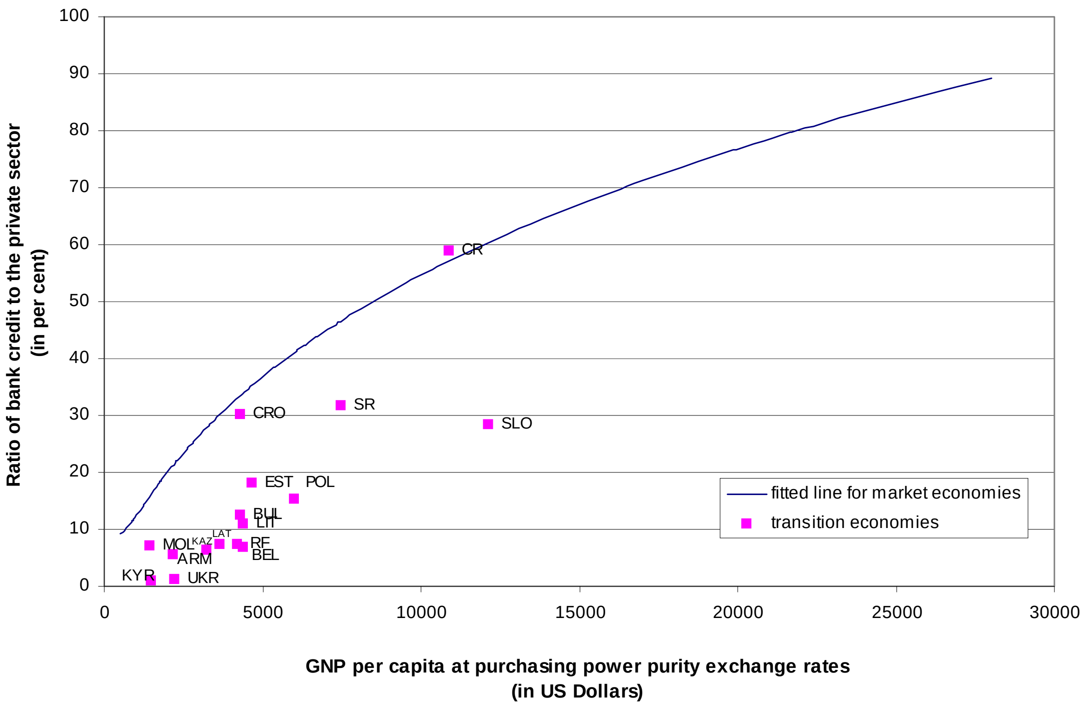
Developing vibrant financial sectors in transition economies was inevitably going to be a lengthy process, given the absence of relevant financial institutions, laws and regulations under central planning. Moreover, the operating environment for financial institutions in the region has been difficult, owing to enormous structural changes, considerable challenges in macroeconomic stabilisation and weak enforcement of financial laws and regulations. The foundations for macroeconomic stability remain fragile, particularly in countries less advanced in the transition, and bouts of instability have severely disrupted several banking systems in the region, most recently and dramatically in Russia. The extent and effectiveness of financial laws and regulations varies significantly across countries and financial activity, with weak effectiveness particular in CIS countries and in securities activities (see Annex 1).

Given the obstacles and the time required for a market oriented financial system to develop, it is not surprising that the scale of financial activity in transition economies remains under-developed and distorted relative to that in comparable market economies. A significant fact about financial systems in transition economies is that they have less depth and breadth than do those of market economies at comparable levels of development.

1.3.1 Banks

Lending by banks is a measure of their activity that captures some of the vital services that they provide to the real economy, particularly in credit allocation. As emphasised in the *Transition Report* 1998, banking systems in transition economies provide less credit and deposits relative to the size of the economy in which they operate than do banking systems in market economies at comparable level of development. It is credit to the private sector, moreover, which is significantly under supplied, rather than credit to the public sector (Chart 1). Banks have invested disproportionately in government securities in transition economies, because of large fiscal deficits and because of poor credit quality and weak creditor rights in lending to the private sector. The relative lack of credit to the private sector is particularly pronounced in the CIS.

Chart 1 Ratio of bank credit to the private sector to GDP by countries' level of per capita income, 1996



Entry by foreign banks provides an indicator of whether countries have succeeded in establishing extensive and effective rules for banking activities. Foreign ownership and entry also presuppose the existence of a largely private banking system, since foreign banks are typically reluctant to compete with domestic banks that enjoy state support. The share of foreign-owned banks in the total assets of the banking system is unusually low in transition economies. Hungary, Poland and Estonia are exceptions;

they have welcomed foreign investment and made considerable progress in bank privatisation.

While the scale of banking activity is under-developed and distorted, the overall financial performance of banks points to the potential for expansion. The average rate of return on assets for banks in transition economies from 1993-97 was about 2.6 per cent, compared with 0.7 per cent in OECD countries This difference, though, reflects both the high inflation rates and high risks in transition economies. The Russian crisis and its repercussions throughout the region, in particular, have revealed the considerable risks in transition banking, arising from both macroeconomic instability and structural weaknesses within the banking sector itself. These risks are greatest in countries at earlier stages of transition.

As important as the level of bank profitability is the way in which banks earn their profits. Available evidence shows that low cost deposits are the main source of bank profits, particularly for banks with a large share of the retail deposit market (typically the former state savings institutions). Healthy lending margins are often offset by high operating expenses and provisions, for both state-owned and private domestic banks. There also is significant evidence of economies of scale in transition banking, reflecting the small size of most banks.

Key challenges in transition banking are thus to expand the scale of banking activity, while sharpening the focus of banks on serving the real economy rather than government. This requires a strong yet limited role of the state in providing an effective legal and regulatory framework for banking and in maintaining macroeconomic stability. Evidence on profitability suggests that banks have the capacity to attract the resources necessary for expanding and improving services. However, ensuring that the resources are directed to the demands from the real economy requires a stronger customer focus. Strengthening competition and advancing bank privatisation are essential. Competition, diversity and variety in the provision of services to the private sector are fundamental to effective intermediation. Openness to foreign participation also strengthens the competitiveness and capacity of the sector.

1.3.2 Non-bank Financial Institutions

The development of the non-bank financial sector has tended to trail development of the banking sector. Leasing companies and life insurance are in their early stages, although this situation is changing, particularly in the accession countries. In a number of countries, state-owned insurance companies continue to dominate the sector. However, privatisations of dominant insurance companies are currently being considered in some countries, partly in response to EU competition requirements. Most central European insurance industries have also attracted substantial inflows of foreign direct investment in new start-ups.

Throughout the region reforms of the state welfare systems have been either initiated or are planned. State-run pay-as-you-go systems are being supplemented by mandatory and voluntarily funded systems operated by private institutions. These three-pillar systems not only will provide for improved pension programs, but also will generate substantial in-flows of local savings into local capital markets.

Private equity and venture capital funds are also very under-developed in transition economies. To be effective, these funds need a strong local presence to develop long-term relationships with entrepreneurs and small companies with strong growth potential. Many international equity funds that operate in the region lack this presence and tend to focus on publicly traded equities.

The key challenge with the non-bank financial institutions in transition economies is to increase the breadth and depth of their activities. Many of these institutions did not exist under central planning and their expansion remains a priority, particularly in leasing, life insurance, pension funds and private equity.

1.3.3 Securities Markets

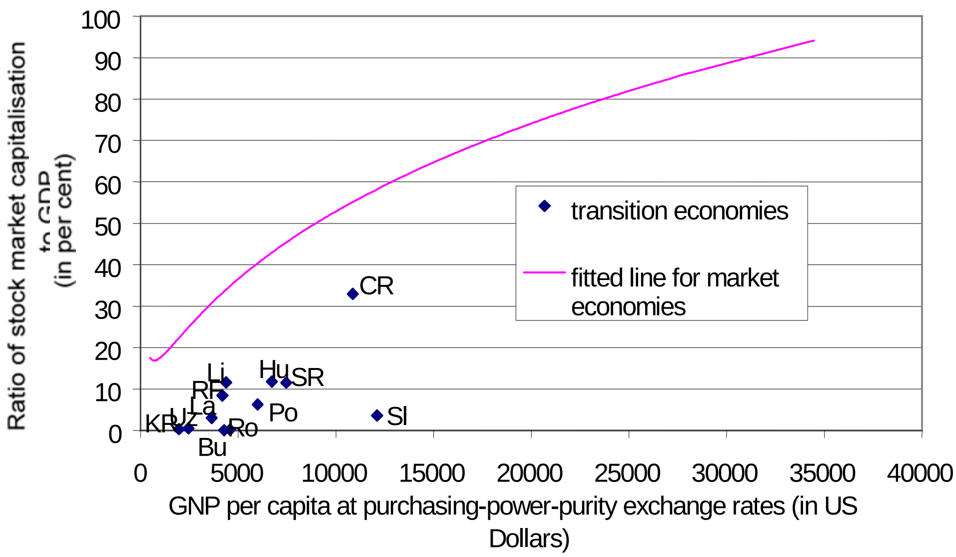
Compared with other emerging market economies, the stock market capitalisation of transition economies remains low (Chart 2). Even the Czech Republic, with the most highly capitalised stock market in the region, has only about half the capitalisation typical for a market economy with its level of per capita income.

Although market capitalisation is uniformly low across the region, turnover has been high in the Czech Republic, Hungary, Poland and Slovenia. Turnover has been relatively high in Poland since the creation of the securities exchange, reflecting a particularly strong regulatory framework. In the Czech Republic, in contrast, turnover has risen recently, stimulated by amendments to the commercial code on disclosure and by creation of an independent Securities and Exchange Commission. The pattern of stock market turnover over time points to the importance of privatisation programmes and a subsequent phase of consolidation in the stock markets. However, the rapid growth in securities activities in some countries has been associated with market abuses and lack of protection of shareholder rights.

Not only are stock markets relatively small and, in many transition economies, illiquid, most have virtually no corporate bond markets. And where bond markets exist, the volume of short-term bonds relative to long-term bonds is unusually high compared with other emerging markets.

Key challenges in securities activities, as in banking, are to strengthen the legal, regulatory and accounting framework, to raise the quality and scope of securities instruments issued by the private sectors (both private and publicly traded securities), to develop liquid benchmarks and to lengthen the maturity of debt issues. Pension reform and the restructuring of dominant state insurance companies can provide a powerful stimulus for the demand for long-term securities.

Chart 2 Ratio of stock-market capitalisation to GDP by countries' level of per capita income, 1996



1.3.4 Financial Crises: Prevention and Response

Rapidly changing and developing financial systems are prone to crisis, not only in transition economies but also in market economies. In Russia, however, the authorities were ill prepared for the banking crisis that began in August 1998. The central bank lacked the key regulatory powers to respond effectively to the crisis, including the power to place troubled banks under administration as an initial step toward their liquidation or restructuring. And once provided with expanded powers, the authorities have been slow to use them. This hesitant approach stands in sharp contrast to the more decisive response to recent banking troubles in Croatia and Estonia. A key challenge in the transition is thus not only to strengthen crisis prevention but also crisis-response measures.

1.4 OBJECTIVES FOR THE BANK'S FINANCIAL SECTOR OPERATIONS

A central objective for the Bank's financial sector operations is to foster development of the sector – to expand the provision of financial services and to raise their quality. This in turn requires the development and maintenance of confidence in financial institutions and markets so that the demands for financial services are placed on the local financial sector. In the absence of confidence, barter will replace bank deposits as a means of payment and savings will be channelled into real assets or foreign currencies. The financial sector must also be focused on serving the needs of its customers, particular enterprises and households. This requires effective **competition** in an independent financial sector. In its absence, incumbent financial institutions will focus primarily on preserving their privileged positions rather than on serving customers. A competitive financial system is a key factor in the reduction of the high intermediation costs in many of the countries of operation. In other words, confidence and competition in an independent financial system are necessary for the expansion of effective financial services in transition economies.

The Financial Sector Operations Policy seeks to translate these broad objectives into **practical operations** that are instrumental in promoting financial sector development. These activities can involve both carefully selected, designed and implemented investment projects and investment climate initiatives. Given the significant differences in historical developments and traditions across transition economies and in the mix of financial institutions and financial instruments in the local financial sectors, the approach to these sectors must be carefully adapted to the conditions in each country of operations.

To foster competition and strengthen financial intermediation, the Bank will aim to select and implement **investment projects** with appropriate characteristics. Financial sector projects should seek to create or to improve markets for financial services, to strengthen corporate governance and business practices in the financial sector and/or to transfer market-oriented financial skills and technology. The appropriate mix of project characteristics for each country of operations will differ according to its progress in transition, degree of macroeconomic stability and other country-specific conditions. The **demonstration effects** generated by investment projects that are well **adapted to country conditions** can provide a dynamic stimulus to the process of competition in the financial sectors in transition economies.

In selecting financial institutions for investment projects, the Bank has preferred private institutions because they have consistently demonstrated that they are more likely than state-owned institutions to respond to the needs of the real economy. While the **privatisation** of banking systems will continue to be a priority, there are circumstances where state-owned banks may be the only practical routes to reach these customers. The Bank has worked with state-owned banks, and will continue to do so, provided that they operate on the basis of sound commercial criteria.

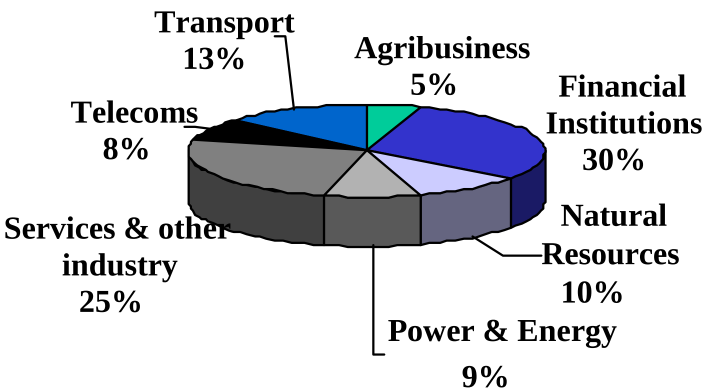
The Bank will also seek to draw upon its extensive experience as an investor in the financial sectors in the region to work to improve selectively the **investment climate**. This experience relates not only to the prudential framework for the financial sector, but also to the resolution of insolvencies of financial institutions, the legal enforcement of secured transactions, accounting and auditing practices in the financial and corporate sectors, bankruptcy procedures for non-financial corporations and corporate governance.

II EXPERIENCE OF THE BANK

2.1 FINANCIAL SECTOR IN THE BANK'S PORTFOLIO

The Bank is active in the financial sectors of 25 of its 26 countries of operations, with preparation of a project well advanced in the remaining country. At the end of 1998, the level of signed commitments reached Euro 3.6 billion in 402 projects, comprising 30 per cent of the Bank's portfolio (Chart 2). Of this amount, Euro 2.7 billion is allocated to 288 wholesale projects, which are primarily SME related. EBRD-supported projects have disbursed over 30,000 loans to sub-projects and have made over 400 equity investments through equity funds. EBRD financing stimulates other financing, both directly through co-financiers and indirectly when Bank financed financial institutions or private equity funds finance sub-projects.

Chart 3: EBRD Operational Portfolio by Sector
(In per cent of total commitments,
31 December 1998)



Within the financial sector, the Bank's investment projects are diversified across countries and underlying risk exposure. Of the Bank's total commitments in the financial sector, 41 per cent is in advanced transition countries, 25 per cent in Russia and 34 per cent in early and intermediate transition countries (Chart 4). Moreover, the underlying risk exposure is diversified away from the financial sector through recourse to sovereign guarantees in some projects in high-risk countries, through assignment of sub-loans in some credit lines and through investments in equity funds. For example, sovereign risk accounted for 28 per cent of the Bank's financial sector commitments and equity funds 21 per cent at the end of 1998 (Chart 5). These project structures give the Bank an investment risk exposure either to the government or to a diversified portfolio of businesses in the real economy and mean that about 16 per cent of the Bank's total operational portfolio has a direct exposure to the financial sector.

Chart 4: Diversification of Financial Sector Commitments by Countries and by Risk Exposure
(In per cent of total financial sector commitments, 31 December 1998)

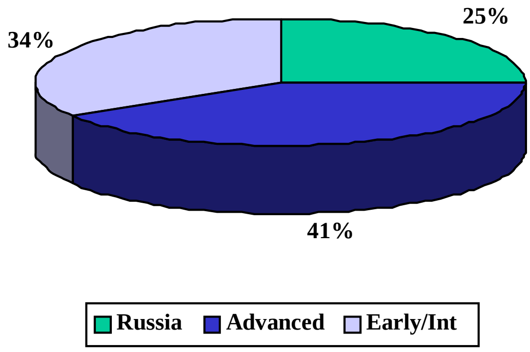
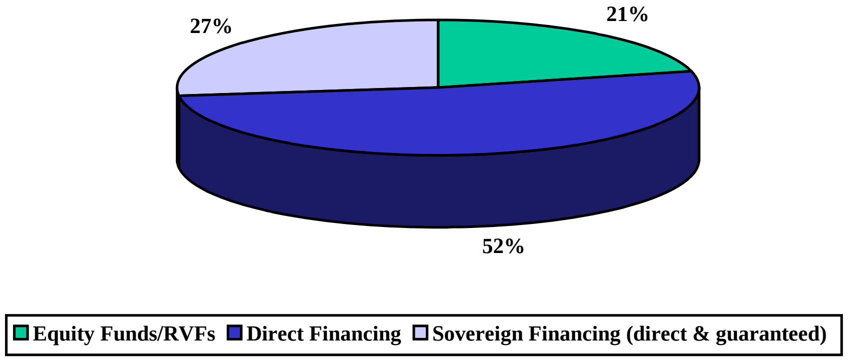


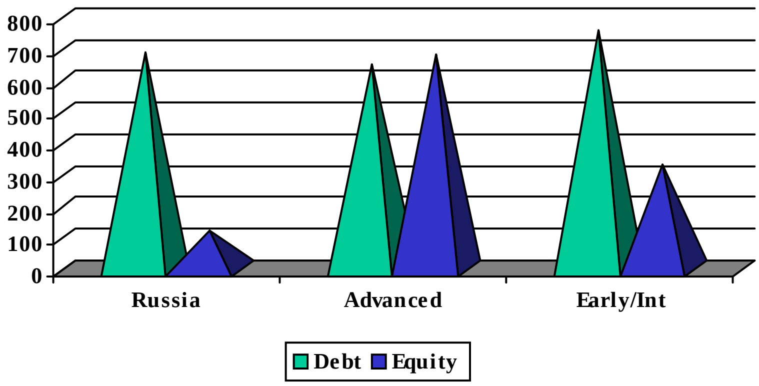
Chart 5: Diversification of Financial Sector Commitments by Risk Exposure
(In per cent of total financial sector commitments, 31 December 1998)



The financial performance of the Bank's financial sector portfolio has benefited significantly from its equity investment in the region's financial institutions (Chart 6). Since 1994, equity investments in financial institutions (excluding equity funds) have generated realised capital gains of Euro 200 million, after taking full account of losses of Euro 27 million and specific provisions on equity investments of Euro 37 million. These capital gains have been earned primarily in countries at advanced stages of transition. The estimated internal rate of return on the Bank's equity investments in financial institutions is 19 per cent, after losses and specific provisions. [1]

[1] The return is calculated by valuing the present investments at market value where it is available or net asset value and it includes cash flows from dividends and divestments, less specific provisions as of 31 December 1998.

Chart 6: Bank Investments in Financial Institutions by Countries' Stage of Transition and by Instruments
(In millions of EUR,
31 December 1998)



The debt portfolio in financial sector operations has shown steady growth in recent years, generating EUR 90 million in fees and interest payments over the period 1995 to 1998. Fee and interest earnings were EUR 32 million in 1998, with specific provisions of EUR 127 million resulting from the Russian crisis.

Notwithstanding the significant scale of its financial sector operations, the Bank has selected carefully its counterparts and placed considerable resources into monitoring the portfolio. This screening and monitoring has proved effective. With the exception of Russia, where a serious systemic crisis has significantly impacted the Bank's investments, all loans to financial institutions are current.

A detailed account of the Bank's financial sector portfolio and activities is available in the annual report on Financial Intermediary Operations and the Annual Report on Equity Fund Operations.

2.2 TECHNICAL CO-OPERATION

The Bank's Technical Co-operation Funds Programme (TCFP) has played an important role in supporting the financial sector operations by financing due diligence, risk assessments, institution-building, training, legal and regulatory reform in the banking sector. In doing so, this programme enabled the Bank to achieve transition impacts in the financial and micro-enterprise and SME sectors while adhering to sound banking principles and additionality.

Cumulative TC commitments in support of the financial sector amount to EUR 198 million as of 1 May 1999, equivalent to 34 per cent of total TC commitments. In 1998 alone technical co-operation funds in support of the financial sector amounted to EUR 39.3 million or 36 per cent of total TC commitments last year. TC support covers such diverse activities as the Russia Small Business Fund, Regional Venture Funds, credit-lines to local banks (credit advice, International Accounting Standards, management information system development), leasing, trade facilitation, post-privatisation and micro-enterprise banks. In all of these programmes, the emphases have been on mobilising funding for SMEs on strengthening local financial institutions.

2.3 DEVELOPMENT OF THE BANK'S STRATEGIES AND OPERATIONS

The Bank's Financial Sector Operations Policy has guided its activities in the financial sector since the first policy was adopted in 1991. The strategy was revised in 1996, responding both to changes in the operating environment and to the Bank's experience as an investor in the region's financial institutions. The initial policy focused on the broad elements of decentralisation, privatisation of state institutions and formation of new private institutions. It also emphasised the need for governments to build sound financial laws and regulations. The revised policy focused on the process of financial intermediation and on institution building to strengthen the performance of financial sectors. The financial sector operations of the Bank have evolved in line with these overall objectives.

2.3.1 1991 Financial Sector Operations Policy

The Bank's earliest objectives for financial sector operations reflected the very low level of financial sector development in the countries of operations and the dominance of specialised state-owned banks. The three main objectives of the 1991 Financial Sector Operations Policy were:

- **Establishment of decentralised financial systems, based on independent banks, both through reform of existing banks and creation of new institutions**. This goal was to be pursued through investment projects aimed at improving the performance of existing banks, often associated with their privatisation, and at supporting the creation of new private banks. It was also recognised that greater competition among banks would work to improve the quality of the individual banks and to spur new sources of financing for the private sector.

- **Establishment of effective regulatory and supervisory institutions**. It was recognised that the central banks needed to divest themselves of commercial lending activities and develop skills needed to supervise the sector through clearly specified prudential regulations. As a transaction-oriented bank, EBRD investments flowed primarily to countries where the regulatory environment was best developed.

- **Establishment of an improved institutional and policy framework.** The Bank's experience in the financial sector was drawn upon to encourage local authorities to reform their financial systems.

The Bank's objectives were pursued through investment operations that incorporated one or more of the following characteristics:

- **Development of financial institutions**, including strategic planning and operational policies such as asset liability management and credit procedures.

- **Market-based terms and conditions**, where the Bank's funds were provided at market prices and sub-projects were selected and priced using market criteria.

- **International Accounting Standards and improved corporate governance**.

- **Private sector institutions** that could best introduce the required skills and qualifications, particular those with **foreign strategic investors.**

- **Privatisation** to encourage former state-owned institutions to focus on operational improvements and on strategic objectives.

- **Local banks and private equity funds** as the key mechanisms for supporting the early development of **SMEs**.

The Bank's portfolio activities in this period reflected this policy, with a focus on building a financial sector portfolio through credit lines and by joining forces with foreign strategic investors.

Support for Banks (1991-1995)

Credit lines for specific sectors or backed by sovereign guarantees:

- Poland Housing, Agricultural Restructuring in Hungary, Enterprise Support Program in Russia, Apex Credit Lines in Central Asia

Creation of new intermediaries with financial or strategic investors:

- Russia Project Finance Bank, investment banks in Bulgaria and the Baltics, BNP-Dresdner Bank in Bulgaria, Bank of Bucharest, Capital SA

Support for bank privatisation in advanced countries

- WBK Poland, Hungarian Foreign Trade Bank, BPH Poland

Non-Bank Activities (1991-1995)

Private Equity Funds to promote equity finance: advanced countries

- Renaissance, New Europe East, Czech and Slovak Investment, Poland Private Equity, Advent

Early/ intermediate countries:

- Ukraine Fund and Framlington Investment Fund in Russia

2.3.2 1996 Financial Sector Operations Policy

When reviewed in *1996, the revised policy* emphasised **institutional strengthening and intermediation** as the key objectives for financial sector operations.

- **Strengthening both the capacity of individual financial institutions and the sector as a whole**. The Bank would seek to work with the highest quality financial institutions. The EBRD would support their capital base to ensure capital adequacy and to participate in corporate governance of the institution. It was recognised that the Bank's equity investments could be leveraged many times over by the investee institution. The EBRD would provide debt financing to the highest calibre institutions that extended the term structure or lowered the cost of their funding. The Bank would also foster competition by supporting new financial entrants and by promoting the introduction of new products.

- **Intermediation through the sector continued to be key to reaching private companies that otherwise would be too small for direct financing by the Bank**. The Bank would support private equity funds and provide local banks with SME credit lines to reach the local private sectors. The Bank introduced new mechanisms for reaching these sectors, including use of Technical Co-operation funds and recourse to co-financing to reach small firms in countries where the financial sectors were less well developed.

From 1996, the Bank's objectives were pursued through operations incorporating one or more of the following characteristics:

- **High quality and preferably private financial institutions**, to create strong demonstration effects.

- **New products and terms not generally available in the market**, to achieve transition impacts and to maintain additionality.

- **Active monitoring of investee institutions, and as needed, sub-projects**, including frequent reporting, on-site visits and placement of advisors.

- **Ensuring owners' involvement owners in governance of the institution and taking a governance role** consistent with the Bank's minority shareholdings.

- **Use of sovereign loans only in countries and institutions considered as high risk**, while looking to remove the sovereign guarantee over time.

- **Developing non-bank financial institutions to expand intermediation, funding and competition**, including leasing companies, equity funds and mutual funds.

- **Targeted TC funds to support both financial institutions and financial systems more generally,** including capacity building in environmental due diligence

The revised policy was reflected in an expanded range of activities, as credit lines were opened in less advanced countries and new products were introduced to reach additional users of financial services. There was an expansion of activity in the non-bank sector.

Support for Banks (1996 – 1999)

Rapid increase in exposure, but the first time, there were indications that the Bank's pricing was not competitive in some of the more advanced markets.

- Credit lines continue to expand, with continued reliance on sovereign guarantees in less advanced countries (Macedonia, Georgia, Moldova, Uzbekistan, Ukraine, Belarus, and Tajikistan).

***New wholesale products were developed*:**

- Trade finance program, with most impact in Uzbekistan and Russia.
- Development of RSBF and similar programs in Moldova, Kazakhstan, Bosnia.

Growth of involvement in new banks, privatisation of state-owned banks and support for successful local banks

- Privatisation efforts moved most rapidly advanced countries – Hungary, Poland

Introduction of more sophisticated funding techniques in more advanced markets

- subordinated and convertible debt

Non Bank Financial Sector (1996-1999)

Continued expansion of non-bank financial sector activities:

- Rapid growth of equity fund investments across the region;
- Leasing companies in Poland and Uzbekistan
- Multi-project facilities in the insurance sector
- Mutual funds in the Czech Republic
- Pension funds in the Czech Republic, Hungary and Poland

Growth in use of donor funds to support intermediation to SMEs:

- RVFs and PPFs in Russia, Ukraine, Kazakhstan
- Expansion of the RSBF program, and development of similar projects in Moldova, Kazakhstan, Bosnia

Section 3.1 of this paper provides a corresponding summary of the 1999 Financial Sector Operations Policy and Annex 3 contains illustrations of how the policy could be implemented.

2.4 IMPLICATIONS OF THE BANK'S EXPERIENCE FOR FUTURE OPERATIONS

The Bank's experience with financial sector operations is extensive and, on the whole, positive. The overall financial performance of financial sector operations has been satisfactory. Moreover, these operations have sought to achieve transition impacts and to maintain additionality by following the financial sector operations policy. According to the evaluation of these operations (see Annex 2), these objectives are most often achieved when operations are adapted to the specific conditions in each country of operation.

While financial operations have broadly achieved their financial and non-financial goals, three specific operational issues nevertheless arise from this experience. They require a strong response. The issues are systemic risk, workouts of troubled institutions and effective corporate governance of financial institutions.

2.4.1 Systemic Risk

Most realised or anticipated losses in the Bank's financial sector operations have arisen from the systemic crisis in the Russian banking system. This crisis had its origins in the weak foundations for macroeconomic stability and the default by the Russian government on its domestic debt, as well as serious structural weaknesses in banking sector. These weaknesses included ineffectively regulated off-balance sheet activities that resulted in large open foreign exchange position.

Given the importance of financial sector operations in fulfilling the Bank's mandate and the goal of being active in all countries of operations, a serious challenge is to develop ways of mitigating systemic risk. The imperative is stronger in countries at early/intermediate stages of transition than in more advanced countries, owing to greater risk of macroeconomic instability and deeper structural weaknesses in the local financial sectors.

2.4.2 Resolution of Financial Institution Insolvencies

Just as the crisis in Russia re-affirmed the potential for systemic risk in transition economies, this event also revealed the problems created by an inadequate legal and institutional framework for the resolution of failed banks. Fundamental to their effective resolution are the ability of the regulatory authority to take administrative control of failed institutions and the legal and institutional framework for bank liquidation or restructuring. These fundamental requirements were largely absent when crisis struck the Russian banking sector. In their absence, the managers and shareholders of many troubled Russian banks stripped away valuable assets and pursued favourable deals with some creditors.

This experience has two important implications for the Bank's financial sector operations. First, clear criteria must be developed for participation in any bank restructuring agreements. Second, the Bank should take a more active approach in identifying weaknesses in the legal and institutional arrangements for the resolution of failed financial institutions and in recommending corrective actions. Clarity on these issues would significantly reduce the risk of investing in financial institutions in the region.

2.4.3 Corporate Governance of Financial Institutions

Experience has shown that very often the Bank's project objectives do not fully coincide with those of key counterparties -- management, other shareholders, regulators or co-financiers. And these counterparties do not always understand the Bank's objectives. Although fostering good corporate governance has been one of the most important objectives of many financial sector operations and a key goal of the financial sector operations policy, practical achievements have sometimes fallen short of these standards. In some cases, the Bank has had too little leverage to influence formal governance decisions, especially when the Bank has been involved only as a creditor. In other cases, even when there is a significant shareholder, the interests of the majority of shareholder have differed significantly from those of the Bank. One of the key lessons from the Bank's experience in Russia is that the Bank needs to develop mechanisms to encourage shareholders and management of financial institutions to take corrective action when problems are identified.

The Bank has often found that good corporate governance and the accompanying improvement in a financial institution's underlying value has been attainable when other foreign strategic investors have been involved and, in advanced transition economies, when prudential regulation and supervision have been strengthened. In any case, the quality of the Bank's investment partners is fundamental to fostering more effective corporate governance, pointing to the importance of understanding their strategic interests. In countries at early/intermediate stages of transition, where the interest of foreign investors is often weak, projects that focus on other aspects of institutional development, such as credit processes, may be more appropriate.

III OPERATIONAL PRIORITIES AND APPROACH

3.1 OPERATIONAL PRIORITIES

The Bank's financial sector policy objectives have evolved in line with the progress in transition and the Bank's experience in the countries of operation. In 1991, the primary objective was to support the establishment of market-oriented financial institutions. In 1996, the focus shifted to financing the real sector and on institution building at the project level. The 1999 policy takes a more systemic and strategic view, focussing on the role of market processes and of government in fostering financial sector development.

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

The selection and design of the Bank's financial sector operations is a crucial factor in shaping the extent to which they have a broader impact on the process of financial sector development. These **broader transition impacts** are achieved by creating new markets for financial services or extending their reach to new customers, by strengthening private ownership, corporate governance and business practices of financial institutions and by transferring the skills and technologies that are needed in a modern market-oriented financial system. These impacts arise not only within the financial sector but also in the real economy given the extensive linkages between financial institutions and commercial businesses.

Specifically, the Bank will seek to **invest in financial sector projects** that possess some of the following characteristics (see Annex 3 for practical illustrations):

- increase the **diversity of financial institutions** and the range of financial instruments in the local financial sector, including **specialised institutions**;
- extend the coverage of the financial sector to **new types of customers**, particularly in the private sector and **small and medium-sized enterprises** (see also "Promoting SMEs in the Transition: A Strategic Approach");
- broaden the **geographical coverage** of the financial sector, particularly to **regions** in which a cluster of Bank operations can reinforce progress in reform;
- strengthen the **corporate governance and business practices** of local financial institutions;
- facilitate **foreign direct investment** into local financial sectors to strengthen private ownership and corporate governance, demonstrate sound business practices and to transfer capital and skills;
- facilitate **mergers within the region** where appropriate, supporting the expansion of those local institutions that have performed well; and
- strengthen the **commercial orientation of state-owned financial institutions**, particularly in preparation for their privatisation; and
- support **privatisation** of state-owned financial institutions.

It should be recognised that in a competitive environment, innovation in the provision of financial services can stimulate a strong response from other market participants. By pushing back the frontiers of the financial sector and by demonstrating the way forward, the Bank can achieve broader impacts from its projects. However, the appropriate mix of project characteristics will depend on the specific conditions in each country of operation. Effectiveness thus requires a **country-based approach**. A financial sector operational approach will be developed for each country of operations on the basis of the objectives and priorities established in the policy paper.

A competitive and innovative financial sector, however, does not mean a hands-off role for government. **Government must take a strong but limited role** to promote confidence, competition and the right kind of investment climate in the financial sector. It is important to recognise that attractiveness of the local financial sector to investors depends on its institutional foundations and structure. Crucially, local banks must command the confidence of depositors. The system must also be competitive, including suitability tests for new entrants and a fair and transparent mechanism for the restructuring or liquidation of insolvent institutions. Effective competition also requires that the financial sector is neither subject to arbitrary government influence nor captive of business interests.

Confidence in financial sectors requires effective prudential regulation and supervision of banks and non-bank financial institutions and acceptable accounting and auditing practices. The IMF and World Bank, together with the Basle Committee on Banking Supervision, IOSCO, IASC and bilateral donors, have traditionally focused on these regulatory issues. The EBRD's project-based experience can provide useful feedback on their efforts and help to identify priorities for new initiatives.

A number of policy issues shape the process of **competition** in the financial sector. For example, **minimum capital requirements** and fit-and-proper tests for shareholders and management in the granting of bank licenses establish basic tests for new entrants that serve to deter fraud and other abuses. There must also be **fair and transparent mechanisms for exit for troubled institutions**, such as clear powers for the authorities to take administrative control of troubled banks and to restructure or liquidate insolvent banks. However, in many financial sectors in the region, there has been considerable undisciplined entry of new institutions and too little exit of non-viable ones. For example, the Bank has been active in promoting fair and transparent resolutions of bank insolvencies in Russia through a dialogue with the Russian authorities and through negotiations on specific investment projects.

A consequence of the under-developed financial sectors is that the size of individual institutions is below that scale which minimises unit costs. This implies that some **consolidation** of financial institutions through mergers and liquidation is desirable in most transition countries, keeping in mind the need to maintain a competitive system and to avoid the emergence of dominant institutions. A challenge will be to apply effectively the principles of competition policy to the financial sector.

Competitive financial sectors also require the **commercialisation of state-owned institutions**, to avoid market distortions and unfair practices. Where institutions remain in state ownership, they typically require substantial restructuring to operate according to strictly commercial criteria and to become viable participants in the financial sector. This restructuring can also be a first step toward privatisation. The participation of quality strategic investors is an important element of a successful privatisation, more so than the nationality. At the same time, it is important to recognise the significant benefits that foreign strategic investors can bring in terms of both additional capital and expertise.

The Bank will continue to encourage and support **privatisation** of banks and non bank financial institutions as a core activity, through participating in the financing and working with co-investors and the authorities to facilitate privatisation.

3.2 ADAPTING OPERATIONS TO COUNTRY CONDITIONS

The Bank has financial sector operations in 25 of its 26 countries of operations and is developing a project in the other country. The Bank's operational principles of **transition impact**, **additionality** and **sound banking** must apply in all countries. It was emphasised, however, in the recent review of the Bank's overall operational priorities, "Moving Transition Forward", that the balance among these principles can vary depending on the stage of transition and other circumstances of each country. To achieve their potential, the mix of financial sector operations must be effectively adapted to the specific circumstances of each country.

Before examining how to adapt financial sector operations to country conditions, it is important to recognise some aspects of these operations that are **constant across countries**. In particular, the Bank's approach aims to provide support to private sector enterprises in all countries, to strengthen the financial sector infrastructure dedicated to **financing growth of SMEs** and to improve the business environment for SMEs.

Uniform environmental requirements also apply to financial sector operations in all countries, regardless of their stage of transition. The Bank ensures the proper implementation of its environmental mandate in its FI operations while respecting the principle of delegated responsibility which characterises such operations. Environmental procedures, with the agreement of EBRD, are tailored to suit the structure of each specific institution. FIs have, at a minimum, to develop and implement environmental procedures satisfactory to the Bank and to integrate them as fully as possible into their credit/investment appraisal and monitoring procedures. They have to comply with the Bank's "Environmental Exclusion List for FIs" which includes activities prohibited by international environmental agreements or where the Bank considers indirect financing would be inappropriate because of the significance of associated environmental risks. FIs submit periodic, typically annual, reports on the implementation of their environmental procedures and on the environmental performance of their investment/lending portfolios. Prior to establishing a relationship with an FI, the Bank conducts environmental due diligence on its potential partner and it proposed pipeline of operations. The Bank will continue to evaluate the environmental standards that should be applied by FIs to each operation. In the more advanced transition economies it is expected that FIs will increasingly be using EU regulations as a benchmark for environmental risk management.

In **early/intermediate transition countries**, there tend to be many potential projects which would generate a significant transition impact and which would satisfy the test of additionality. However, the challenge is typically to find projects that can also satisfy sound banking principles. The high risk in these countries reflects both significant systemic risk and high project risk because of the lower level of financial sector development. In these countries, the Bank will seek to mitigate the significant risk of investing in financial institutions in a potentially unstable environment in a number of ways. If the risks are very high, the Bank will seek sovereign guarantees and look for opportunities for risk sharing with donors (such as has been successfully done in the Russia Small Business Fund). The sovereign guarantees could be structured to cover specific, well-identified risks under the government's control. The Bank will also work with foreign technical partners to reduce project risk through technical co-operation. Every effort will be made to improve the value of collateral, including the assignment of sub-loans and other assets when local financial institutions are used as intermediaries for on-lending.

There will be a selective focus on equity transactions since the risk profile of equity in these countries is often similar to debt. With equity, the Bank will have the added opportunity to share in the financial gains from successful projects and the potential for greater influence over corporate governance. As countries advance towards the intermediate stage, there tends to be greater interest by foreign institutions in direct investments in local institutions and in participating as investment partners with the Bank.

In some early/intermediate transition countries, it can be very difficult to find co-investors for private equity funds, and donor sponsored funds with significant technical co-operation resources become very important. However, as countries advance towards the intermediate stage, the improved investment climate will generate more interest from co-financiers.

SME financing and smaller investments can have a very significant transition impact in these countries and the Bank will have to consider accepting higher risk in some instances.

A dialogue on the investment climate in the financial sector with the authorities and with other donors is particularly important in early transition countries. The Bank will draw on its experience as an investor to provide feedback and to take investment climate initiatives with the authorities, co-ordinating closely with the other International Financial Institutions.

One of the important lessons learned from the Bank's experience in Russia is that the Bank needs to focus on investment climate issues at the same time as it deals with projects.

In **advanced transition countries**, there is often strong availability of financing from private sources, posing a challenge for the Bank to maintain its additionality. At times, significant competition, and in some cases over-optimism, can result in very aggressive pricing in the market. The Bank will continue to generate project opportunities by introducing new financing instruments, such as subordinated debt for banks, by pioneering new services, such as insurance, pension funds and leasing and by promoting commercialisation and privatisation of remaining state-owned financial institutions.

The Bank's stability as a long-term investor, as evidenced by its remaining engaged during difficult periods, enhances the Bank's attractiveness as an investment partner to both local and foreign investors. However, for the Bank to continue to have influence and to be able to participate during downturns, it will have to participate in the upturns and consideration will be given to a more flexible pricing regime. The Bank will also seek to deliver new and innovative products.

In advanced transition countries, the investment climate initiatives will focus on strengthening the framework for competition. Particular emphasis will be placed on the institutional arrangements for resolving insolvencies of financial institutions, on suitable entry tests, on policies toward sector consolidation and on commercialisation and privatisation of remaining state-owned institutions. Such investment climate initiatives will be undertaken in co-operation with the other IFIs. The Bank will also provide feedback to the other IFIs on its investment experience to help reinforce their efforts to strengthen prudential regulations.

3.2.1 Country Operational Approach

A country-specific operational approach will be developed for each country of operations on the basis of the objectives and priorities established in this policy paper. The approaches will be based on assessments of:

- the main risks to macroeconomic stability
- the key challenges facing the financial sector
- the market mechanisms and financial institutions that will drive the process of financial sector development
- the strengths and weaknesses of the legal, regulatory and supervisory framework; and
- how the Bank's investment projects and investment climate initiatives can best influence the process of financial sector development.

These assessments will assist in monitoring the Bank's existing exposures and provide guidance for identifying the types of investment projects that should be supported by the Bank, as well as for setting priorities for other activities, such as technical co-operation and investment climate initiatives.

The financial sector operational approaches will be co-ordinated with the Bank's country strategies and will be reflected in the country strategy papers as they are revised.

3.2.2 Flexible Pricing

A significant issue faced by the Bank is pricing of private financial sector projects in advanced countries. The Bank intends to be active in all countries of operation until they graduate. To achieve this, the Bank will have to **price flexibly** and competitively.

The pricing of private sector projects is the responsibility of management. In practice, the Bank has tended not to price private sector projects below sovereign projects in a country of operation. In particular, the Bank has not typically offered private sector clients in advanced countries interest rate margins of less than the one percent rate for sovereign borrowers. Future pricing will be based on market conditions and the Bank's assessment of cost and risk.

3.2.3 Assisting in Improving the Legal Environment

Law underpins stable financial markets and is an important source of their vitality. In the aftermath of the emerging markets turmoil and the crisis in Russia, the important role that the legal environment plays in the transition process of our countries of operations can not be overemphasised. Accordingly, while improving the legal environment of each of the Bank's countries of operations is a country-specific issue and shall be dealt with on a country-by-country basis, the general direction for improving the legal environment in the area of financial sector is to move toward internationally accepted norms and standards (see Annex 1).

In particular, adoption of the Basle Committee's "Core Principles for Effective Banking Supervision" and the "Objectives and Principles for Securities Regulations" advocated by the IOSCO will be encouraged. For EU accession candidates, approximation to EC framework for financial services and relevant directives will be the focus. For the less advanced countries, improving the basic legal framework relating to corporate governance will be a priority.

3.3 ENHANCING PROJECT SELECTION, DESIGN AND IMPLEMENTATION

In addition to country-based approaches to financial sector operations, the Bank will take steps to enhance project selection, design and implementation within this strategic framework. This section expands on the project selection criteria set out in section 3.1 and develops responses to the experiences from existing operations, particularly with respect to systemic risk, restructuring of troubled institutions and corporate governance.

3.3.1 Decentralisation and Diversity of Institutions and Instruments

A developed financial sector is one that has the capacity to provide a broad range of financial products to a wide spectrum of enterprises and households. This capacity requires of a financial sector a diversity of financial institutions and instruments. The Bank actively promotes the development of private financial institutions and competitive financial systems, but does not have a rigid view on the specific form the system should take.

Central to the Bank's renewed operational policy is a commitment to work with a broad range of financial institutions, focussing on but not limited to the best private commercial banks in the financial sector. The range of institutions will include:

Banks

Branch and Regional Banks

The Bank will support local banks with extensive branch networks and an ability to distribute their services across the country. These banks often have the local network that is necessary to reach SMEs and other retail customers, although many lack the necessary decision-making structures and processes at the local level. The Bank will also support well-managed regional banks that are focused on serving the needs of a specific region. Also, by clustering projects in a carefully selected region, the Bank can achieve a critical mass of activity in support of reforms at the sub-national level.

Savings Banks, Co-operative Banks and Credit Unions

The Bank has some experience with savings banks and co-operative banks. These banks usually have extensive distribution networks and access to retail customers. They have a core depositor base and can provide effective channels to reach small and micro business borrowers. As consumer finance and residential mortgage markets develop further, they can be useful in developing these markets as well. Although not yet well established in the countries of operations, credit unions could be an additional type of banking institution focused on attracting individual depositors and on serving the micro business and consumer loan market.

Most of the existing savings banks need to be restructured to establish viable commercial operations, with good corporate governance, an independent Board and a focus on serving their customers. The Bank will look for opportunities to encourage and support co-operation with the European savings banks, through investments and technical co-operation programs.

Small Business Banks

While the Bank has a preference for, and has been successful in, delivering micro-credit programmes through existing institutions, there are situations where the existing financial system is not capable of delivering the product, such as post-crisis Russia and Bosnia-Herzegovina. In these circumstances, the Bank has established specialised micro-credit banks. These institutions have shown good progress and the Bank will support micro-credit banks in other countries of operations, subject of mobilising other shareholders and funding.

Development Banks

Development banks have the potential to reach market segments not served by existing financial institutions, particularly in the provision of long-term finance for fixed investment in some areas of infrastructure and industry. Experience with development banks suggests that several conditions must be met for them to both reach new market segments and to achieve commercial viability. Such a bank should neither dominate the financial sector nor hinder the development of other commercially viable institutions. It would need a committed strategic investor who would support the institution with financing, with expertise to reach the difficult market segments and with resistance to arbitrary political interference. It would also need to offer a range of services and to develop a diversified portfolio that is commercially attractive. This would require its lending polices and practices to be based on commercial criteria. It would need to be of sufficient size to be competitive, commercially driven and not politically motivated. Given the experience of the region with directed lending and government interference, the importance of these conditions gains added weight.

The Bank would consider supporting development banks in specific circumstances where these criteria are met.

Non Bank Financial Institutions and Capital Markets

Private Equity Funds

The private equity fund activities of the Bank are a core way of providing equity to SMEs in the countries of operations. Private equity funds have demonstrated a high multiplier effect as the Bank's presence mobilises substantial amounts of other investments into the funds. The equity provided by EBRD's funds allows the local investee to attract further loans and investments from local and international investors.

The Bank is currently the largest investor in private equity funds in the region and will address the lessons learned from the initial years of activity to improve its performance and effectiveness. It will therefore continue to support and monitor its current portfolio of private equity funds while consolidating and progressively privatising those funds which are mainly donor-supported.

The Bank's criteria for new investments will focus on the best performing existing fund managers raising further funds; supporting the establishment of new high standard first generation funds in countries less advanced in the transition process and investing in new regional funds targeting specific key sectors or market segments. One of the key criteria will be management by experienced professionals operating out of local offices.

Other Non-bank Financial Institutions

Non-bank financial institutions, such as insurance companies, pension funds, leasing companies and consumer finance companies are particularly under-developed in the transition countries and represent a significant opportunity for the Bank to participate in the broadening and deepening of transition. Apart from their direct impact on the availability of specialised financial products, insurance companies and pension funds have a demand for long-term financial assets and can be instrumental in lengthening the maturity of local financial instruments. Leasing companies increase the financing options for companies and can provide a strong impetus to competition. For micro and small business, leasing is often the only financing option open to them and can be the first step in building a longer-term relationship with a financial institution.

One of the major constraints to the development of non-bank financial institutions has been the legislative framework. Recent legislative changes in some countries have improved the prospects for insurance companies and private pension funds and the demand for long term funding in many of the transition countries will provide an asset base. In other countries, legislative changes are still required if insurance companies and pension funds are to become effective participants in the marketplace. Long-term local currency instruments will be slow to develop until the authorities have demonstrated that they are able to achieve sustainable macroeconomic stabilisation.

Local Currency Financing

For many of the Bank's target clientele, foreign currency financing exposes the borrower to foreign exchange risks that it cannot manage effectively. The development of financial instruments denominated in local currency is thus important to these clients and to advancing transition. The Bank has established a working group to explore ways in which it can support the channelling of local savings into local investments.

The group pools the Bank's resources in an effort to determine whether and how to pursue local currency operations in specific countries. By analyzing both the project pipeline and capital market development, several countries at fairly advanced stages of transition have been identified as having potential for local currency funding efforts. Given the particularly strong borrower and investor demand in Poland, a zloty borrowing facility and a zloty-funded credit line are likely to be arranged in 1999. Work in other countries of operations will continue in order to make funding locally a more viable option for the EBRD, particularly by negotiating supranational or quasi-national government status within the local issuing regimes and ensuring safe settlement.

Foreign Financial Institutions

Foreign institutions bring both capital and expertise to the local financial markets. Whether they operate as strategic investors, as twinning partners or as branches of international parents, they add to the competitive environment and become a catalyst for the development of the local financial system. In some countries where the supervisory system is not fully developed, the foreign strategic partner is an important element in the oversight of the local financial institution. The Bank should be prepared to provide both funding and equity to joint ventures when it complements a significant commitment in funding and transfer of technology and skills by the foreign investor.

3.3.2 Intermediation and SMEs

A key objective of the financial sector is to mobilise savings and to allocate these resources effectively to investment opportunities in the real economy. A particularly vibrant part of the real economy in most transition economies is the SME sector. However, this sector is often not served well by local financial institutions. Therefore, SME promotion is a priority for the Bank and its approach in this is set out in "Promoting SMEs in the Transition: A Strategic Approach (BDS99-74)". In particular, the Bank will continue to focus on operations with local financial institutions that provide financing to the real economy and in particular that focus on SMEs as clients.

To achieve these objectives, financial institutions supported by the Bank with SME credit lines should have several characteristics. They should make their financing and investment decisions on commercial criteria, independently from governments and commercial shareholders. They should have the capacity to reach a broad spectrum of the population, in particular through their branch networks. The Bank will thus focus on wholesale operations with large private retail banks. Particular efforts will also be made to support to regional institutions, particularly in large economies. The partner banks should be among the leading institutions in the country or in a region, or there should be indications that it has the characteristics to become one. These characteristics include committed and capable shareholders, good management, and a viable business strategy.

Apart from the immediate benefits of Bank financing for SMEs through local financial institutions, such projects will also seek to build the capacity for ongoing SME finance. The Bank recognises that its financing can stimulate learning and innovation in participating banks and private equity funds. This building of financial institutions will continue to be an important element of the Bank's projects, as it seeks to introduce best practices at both the corporate and the systemic levels.

3.3.3 Capital Markets

The establishment and development of capital markets is fundamental to the transition, as emphasised in Article 2 of the Agreement Establishing the Bank. The refocused operational priorities and approach for the financial sector seek to advance capital markets in the region in several ways. There is a strong emphasis on private equity funds and non-bank financial institutions to boost the demand for both privately placed and publicly offered securities in the form of both debt and equity. To increase the supply of local debt securities and to establish pricing benchmarks for liquid instruments, the financial sector operational priorities include local currency operations. There is also considerable emphasis placed on improving the legal and regulatory framework for securities activities. More generally, the importance of capital markets is recognised through the policy paper, including in the assessment of the financial sectors in the region and in the experience of the Bank.

3.3.4 Sound Banking

The Bank will seek to be active in the financial sector in all of its countries of operation. This diversification provides for some risk reduction for the portfolio as a whole. However, the financial performance of the Bank's portfolio and its ability to develop projects in countries where the risk of macroeconomic instability and systemic crisis is high requires careful attention to risk management and mitigation.

Comprehensive Portfolio Management and Monitoring

The Bank's financial sector portfolio is large and complex. It is moving toward more sophisticated products in advanced transition countries and toward greater exposure in earlier transition countries. As set out in "Moving Transition Forward" with its emphasis on strategic portfolio management, the Bank will seek to manage its flow of new commitments in the financial sector to achieve a balanced portfolio that achieves key transition impacts, while maintaining additionality and an acceptable risk/return profile. Furthermore, the Bank will continue with its comprehensive and ongoing monitoring, which has been a key element in project implementation.

Risk Mitigation in Project Design

The specific design of investment financial projects has a significant impact on the risk exposure of the Bank. In some projects, risk reduction can be effectively achieved by requiring collateral where it is available or by risk-sharing arrangements with co-financiers and/or donors. In projects involving the on lending of Bank funds, the assignment of the sub-project loans has been proven to be a successful method of enhancing the Bank's security. However, in countries where there is insufficient strength in the banking system and inadequate collateral, reliance on state guarantees may be required, particularly where the state's polices and practices are a key factor affecting the level of risk. Recourse to state guarantees, including specific policy-related guarantees and temporary guarantees that lapse in response to specific measures, could enable the Bank to pursue high transition-impact projects that would otherwise not satisfy sound banking principles. The Bank will intensify its efforts to develop innovative risk mitigating project structures.

Maintenance of Capital Adequacy

Capital adequacy requirements in transition economies are as important as in advanced industrialised counties in managing risk in the banking sector. The Bank has always required commercial banks with which it does business to maintain adequate capital and to take steps to preserve that capital. Banks in high inflation countries with unstable currencies, however, have experienced significant losses of core equity in hard currency terms through currency devaluation. Attempts to preserve the value of their capital by maintaining it in hard currency have often been met with tax claims for "gains" in local currency terms resulting from currency devaluation. The Bank will work with client banks and the authorities to find methods to preserve bank capital in these difficult environments.

3.3.5 Dealing with Troubled Institutions

The Bank's mandate and the difficult operating environment mean that inevitably some client institutions will encounter troubles. Quality, experience and integrity of management are key to reducing the occurrence of difficulties, but they will occur. The Bank has an important pro-active role to play in identifying troubled situations, analysing them to distinguish insolvency from illiquidity and ensuring that appropriate action is taken. The Bank's high profile places its conduct in these situations under close scrutiny. The Bank, its clients, co-financiers and the authorities must recognise that there are limitations to what the Bank can achieve in some circumstances, particularly where it is a minority shareholder.

The Bank is not a purely commercial investor in the financial sector and the delicate process of communicating its actions and findings without generating loss of confidence in financial institutions and systems will need to be handled carefully. With the co-operation of the authorities, a transparent and expeditious process for dealing with troubled situations will be pursued.

The Bank will seek to apply the following principles when it deals with an insolvent bank:

- Insolvent banks should be identified and either restructured or liquidated quickly in an orderly and transparent fashion.
- While restructuring is preferable to liquidation, both to preserve the franchise value of the individual banks and in some extreme cases, to maintain a functioning banking system, if agreement on a restructuring process cannot be reached in a short time frame, the bank should be liquidated.
- The preferred solution will be to arrange a voluntary restructuring following the principles of the bankruptcy laws, although the Bank will be prepared to pursue its rights under the bankruptcy laws and to test the courts' administration of them.
- The restructuring should be part of a plan to restore capital adequacy to the target institution. The primary objective is to re-establish the functioning of a viable financial institution with adequate capital and liquidity, and not to compensate those who may have lost asset value.
- Depositors' rights must be respected. As the least cohesive group in the process, depositors have often tended to have their rights receive little attention. This does not necessarily mean that depositors will be compensated fully but it does mean that they must not be treated unfairly.
- All unsecured creditors should be treated equally and there should be no distinction drawn between long-term and short-term creditors.
- Restructuring, or liquidation, should proceed in an open, fair and transparent manner. The relative priorities established in the bankruptcy legislation must be respected and the process must be seen to be fair.

Application of these principles requires working with the authorities, creditors and shareholders in a clear and open process. Moreover, shareholders and management must be held accountable for the financial performance of their institution. Bank management that has failed to perform adequately should be changed. Shareholders must recognise that the purpose of restructuring or liquidation is to protect the integrity of the financial system and not to protect them from losses. In most cases, shareholders would lose most if not all of their investment.

3.3.6 Corporate Governance

The Bank will insist on high standards of corporate behaviour at all levels of its investee financial institutions. Company charters will be reviewed to ensure that they reflect appropriately the principles of corporate governance recently adopted by the OECD. Since the Bank is typically a minority investor, it may require explicit agreements with specific covenants and undertakings to ensure that all participants have compatible objectives, with sufficient leverage to encourage compliance. It will also require active participation on the part of the Bank to ensure that high standards are set and maintained by the shareholders, the Board of Directors and the management.

A key element of good corporate governance is transparency. The Bank will seek to ensure that investee financial institutions operate in a transparent manner, with proper disclosure of information to both their Board of Directors and the supervisory authorities. This will require diligence and discipline on the part of the Board members and external auditors. A financial institution's external auditors are an important aspect of the corporate governance process and the Bank will seek to ensure that the relationship between the financial institutions and their auditors is beneficial to the process

The Bank has placed 26 employees on 65 financial institutions' Boards of Directors or Supervisory Boards. Bankers appointed for these tasks are experienced professionals with appropriate credentials, including working on boards, familiarity with corporate governance issues, and an ability to contribute effectively to institution building through active participation in these bodies. The Bank will also make increasing use of experienced nominees from outside the Bank to serve on these Boards. These experienced bankers will receive enhanced support and guidance from the Bank in carrying out their responsibilities.

3.3.7 Relationship with Co-financiers

An important feature of the Bank's financial sector operations is co-operation with co-financiers, both official and private. Co-operation with other International Financial Institutions occurs at many levels, from policy dialogue to technical co-operation projects recognising the different roles, responsibilities and strengths of the IFIs. Co-operation with other financial institutions is important for sharing financial risk and for promoting transition. The Bank adds value to these financing structures based on its expertise and its position as the largest investor in the financial sector in the transition countries. However, care must be taken to ensure that all parties recognise that the Bank is not an implicit guarantor for other investors' exposure and that every investor is responsible for their own due diligence. In addition, while the Bank does not expect to receive special treatment in private sector projects, it does seek to be treated as well as other investors and creditors.

3.3.8 Co-operation with Other International Financial Institutions

The Bank has developed a close and effective working relationship with the other IFIs in the financial sector. The IMF and the World Bank have taken the lead on sectoral reform issues. The Bank is a major investor in the financial sector in the transition economies, particularly in private initiatives. The Bank has actively shared this investment experience with the other IFIs to help shape sectoral reform institutions. The Bank’s objectives with respect to the investment climate in the financial sector will make this co-operation and co-ordination even more important.

3.3. 9 Technical Co-operation

The Bank's technical cooperation activities in the financial sector will be closely aligned to the Bank's strategic priorities. TC interventions will be defined on a country-specific basis, depending on the country's reform commitment, the prevailing investment climate and the quality and composition of the financial sector itself. More specifically, technical cooperation will support the institutional development of existing banks, the establishment of new financial institutions (e.g., micro-finance banks) and the needs of the SME sector, including business support networks. It is the intention that TC programmes will comprehensively address the relevant issues at several levels: improvement of the investment climate in the financial sector through legal and regulatory provisions, institution-building (lending capacity of local banks; business advisory services for SMEs) and support the preparation and implementation of concrete banking sector projects.

The Bank will continue to place emphasis on capacity building initiatives related to environmental risk management. The provision of environmental training for the Bank’s FIs, funded by the PHARE and TACIS programmes, will continue, emphasising both the credit risk of failing to take appropriate account of environmental liability and related factors, and also the positive opportunities for SMEs represented by environmental investments. This will also be addressed via a new TC providing assistance to SMEs in the preparation of projects to promote cleaner production. Additional training for environmental consultants in the Bank’s countries of operations will be provided; in the advanced transition countries particular emphasis will be given to EU accession related issues.

GLOSSARY

GDP	**Gross Domestic Product**
GNP	**Gross National Product**
IFI	**International Financial Institution**
IMF	**International Monetary Fund**
IOSCO	**International Organisation of Securities Commissions**
IASC	**International Accounting Standards Committee**
OECD	**Organisation for Economic Operation and Development**
PPF	**Post Privatisation Fund**
RSBF	**Russia Small Business Fund**
RVF	**Regional Venture Fund**
SMEs	**Small Medium Sized Enterprises**

ANNEX 1

MARKET PERCEPTION OF FINANCIAL LAWS IN THE REGION AND AREAS OF POTENTIAL LEGAL TECHNICAL ASSISTANCE

I. Market Perception of Financial Laws in the Region

In July and August 1998, before the Russian crisis transpired, the Office of General Counsel conducted a survey of how lawyers and other specialists working in the Bank's countries of operations perceive the legal and regulatory framework governing banking and capital markets. The results of the survey were published in the spring 1999 issue of *Law in transition*. Below is a synopsis of the market perception of the financial laws in the region, as derived from the survey:

- **Perception of the banking regulations**

1. Effective regulatory supervision and enforcement remain weak. While many countries have well-developed legal systems with respect to banking and financial institutions, serious problems with enforcement and implementation of these laws and regulations exist. Major impediments include a lack of trained regulatory personnel, a failure to conduct regular supervisory examinations of financial institutions and an inability (either technically or politically) to take prompt and frequent corrective action with respect to problematic financial institutions.

2. Stricter licensing requirements and entry requirements have been introduced by most of the countries in the region. Capital and other requirements for chartering new banks have become mechanisms for guarding against risk and fraud. In many countries, minimum capital requirements are consistent with minimum international standards. Such requirements limit the number of banks that exist in a jurisdiction, but ensure that the banks that do exist have a stable financial base. This assists the banks to promote reliable lending and growth activities. As a result of stricter licensing and entry requirements, banks have been consolidated in many jurisdictions and those that are insolvent or unstable have been forced to merge or exit. There is a lag, however, with respect to proper assessment of the effect of improved regulations. On-site examination of financial institutions needs to be improved in order to monitor the change in entry requirements.

3. The prudential requirements have been tightened in those countries that have already experienced financial instability and bank failures. From 1995 through 1998 many jurisdictions have amended and supplemented their banking laws to further improve regulatory coverage. Other nations who have only recently enacted new legislation have done so after learning from the experiences of other east and central European and former Soviet Union countries. With regard to capital adequacy requirements, while the 8% capital-asset ratio proposed by the Basle Committee is a minimum standard, some countries have adopted a higher percentage requirement. However, it is unclear how such ratios and risk weighting of capital occurs or is measured by the regulator.

4. There is a general lack of a legal requirement that financial reports be prepared and presented in accordance with the internationally accepted accounting standards. Combined with the lack of consolidated accounts and supervision, this may make it difficult for regulators to properly assess certain indicators of the strength of a financial institution.

- **Perception of the capital markets regulations**

1. The EU accession candidates were perceived to have the most developed regulatory framework. However, the trading volume remained low, even in more developed markets such as the Czech Republic, Bulgaria and Romania. These nations were perceived to need to focus on the creation of pension or investment funds and to refine and improve investor protection measures in order to encourage individual investment.

2. Investment funds are largely unregulated, leading to prevalence of confidence schemes in many jurisdictions. Poor regulation of investment funds has allowed certain entities and individuals to profit from illegal and fraudulent pyramid schemes or investment scams. The absence of disclosure requirements for such investment funds has allowed organisations to publish inaccurate and misleading information that has attracted investors. The confidence schemes transpiring in Albania, Russia, Romania and FYR Macedonia are all good examples.

3. The development of self-regulatory organisations needs to be strengthened. It was perceived that for most of the jurisdictions, there is less development with regard to these organisations.

4. The laws regulating market intermediaries are not effective. One example is that most licensing frameworks for broker-dealers require individuals only to register rather than requiring them to possess certain minimum credentials or qualifications. Therefore, while countries may have laws concerning broker-dealers, the laws are not "effective" because they do not necessarily impose qualitative restrictions on those who participate, nor do they provide clear guidance as to permitted and prohibited activities of such intermediaries.

II. Areas of Potential Legal Technical Assistance

Subject to meeting the requirements below, the Bank, if requested by a government in the region, is prepared to provide legal technical assistance in the following areas:

- Institution building projects to provide assistance to securities commissions or supervisory authorities;
- Developing capital markets through legislation (e.g., pension and investment funds);
- Assisting in legislation for bank restructuring and insolvency; and
- For more advanced countries -- sophisticated capital market assistance covering e.g., derivatives transactions, local currency borrowing, etc.

The Bank could provide assistance in additional areas, such as bank regulation and leasing law development, provided additional sources were identified.

In line with the principles of the Bank's Legal Transition Programme, the following preconditions should be met before a prospective legal technical assistance project is undertaken:

1. **Availability of necessary funding and resources within the Bank.**

   Funding and other resources necessary for the Bank to undertake the relevant legal technical assistance project shall be secured.

2. **Government's firm commitment and involvement.**

   The relevant government has to demonstrate its firm commitment to making reform in the financial sector; the relevant department or agency of the government shall be directly involved in pursuing the project undertaken by the Bank.

3. **Co-operation.**

   The Bank shall closely co-operate with other multilateral and bilateral legal reform providers in the financial sector, especially the World Bank and the IMF, in order to avoid any overlap in the Bank's legal reform efforts. This will also ensure that the comparative advantages of each institution are utilised most effectively to support the transition process of any given country.

ANNEX 2

LESSONS LEARNED FROM EX-POST PROJECT EVALUATION

A representative number of financial sector projects (by size, product, country, and success rate) have been reviewed within the Bank's established ex-post evaluation process. The following thematic synthesis of Lessons Learned, which has been provided by the independent Project Evaluation Department, has influenced the drafting of the new Financial Sector Operations Policy.

Country/sector strategy

It is important to adapt the level, timing and instruments of financial sector intervention to the specific economic position of each country of operation. In so doing, financial sector projects can more readily meet the Bank's three key mandate objectives of sound banking, transition impact and additionality in all countries.

Financial sectors have been seen to change and consolidate extremely rapidly. Formula type approaches need to be constantly revisited. Forward-looking analysis of banking sector and participant dynamics need to take regional and international objectives and contexts into account.

Client/intermediary selection

The Bank's preferred policy of developing projects with private or privatising banks has facilitated more harmonious partnership and positive demonstration effects in many cases. However, there have been diversification (product, client and geographical) limits to the impact these projects can have. The Russian crisis - and developments in other countries of operation - have suggested that the Bank needs to have greater regard for developments in countries' financial markets and ensure that there are relationships with the key players in the sector on the basis of impact and not just ownership. The maintenance of low key relationships with state owned institutions which operate on independent market principles has been seen to be potentially very beneficial at times of crisis or policy shifts. The Bank should maintain a selective rather than comprehensive approach to the banks with which it works in any particular market, and should be cautious in working with existing banks with very small market shares, especially in advanced transition economies where other larger banks demonstrate growing degrees of efficiency.

Due diligence

Due diligence for equity transactions are more extensive than for credit transactions, and must take full account of management and shareholder motivation and intention. All due diligence should stress quality of earnings, business planning and management while being very cautious about placing too much reliance on audited accounts. Due diligence should confirm that the Bank's capital contribution can be expected to have influence as intended and to be protected as much as possible from devaluation and misappropriation.

Corporate governance and institution building:

Experience has shown that the Bank's project objectives do not always coincide with either the objectives of key counterparties - management, other shareholders, regulators, and cofinanciers - or with those counterparties' understanding of the Bank's objectives. Fostering good corporate governance has been one of the most important objectives of many individual financial sector projects and a key element of sectoral policy; however practical achievements have fallen short of acceptable standards in some instances. In some of these, the Bank had too little leverage to influence formal governance issues, especially when the Bank has only been involved as a creditor. In other cases, even where the formal side of governance was improved, the fortunes of the institution did not demonstrably improve in the short term because of other more pervasive market or economic imbalances, and the benefits of good corporate governance were not convincingly revealed in practice. The Bank has often found that good corporate governance and the accompanying improvement in a financial institution's underlying value has only been attainable when other foreign strategic partners have been involved and, in the more advanced transition markets, where the regulatory and supervisory framework have been tightened and attention given to building effective implementing and enforcement institutions. In less advanced markets, experience has suggested that the Bank might have concentrated more on institutional development until necessary improvements and conditions for financing were achieved.

Systemic risk mitigation

The Bank's room for manoeuvre in ailing financial sector operations is likely to be limited, as long as the survival of the existing institution has systemic implications. This is because of the 'confidence' factor involved in all international banking operations and especially those related to EBRD investments. The Bank is therefore obliged to act speedily to try to arrange solutions to an ailing bank's problems.

Transition impact, SME and 'real economy' financing:

Post-evaluation findings have confirmed that transition impact in the financial sector should be expected to have clear qualitative as well as quantitative aspects. Projects should aim to increase the confidence of depositors in the banking system while ensuring transparent, treatment for borrowers. A good quality loan portfolio had been seen to have greater impact than merely a fast growing loan portfolio. Even before the Russian crisis, transition impact had been seen to be smaller when banks concentrated on the development of international rather than domestic business funding and built up holdings of government securities rather than healthy loan portfolios. Financial and technology transfer leverage in credit line projects are best raised when the Bank's projects are handled by the participating bank's main lending department rather than by its international department. Impact on the real economy is more certain when credit lines also reach borrowers outside countries' capital cities

Promotion of environmental awareness

The environmental due diligence training provided by the Bank to financial institutions has been an effective programme that, with a due degree of insistence by the Bank, has promoted new understandings of environmental issues, responsibilities and means of enforcement. The challenge remains to ensure that the new approaches are sustained after the Bank's involvement has ended. To achieve this, the programme needs not only to be continued at individual bank level but also more closely integrated with host countries' environmental programmes, legislation and professional bodies, as well as co-ordinated with the work and programs of other IFIs.

ANNEX 3

THE BANK'S TRANSITION OBJECTIVES IN THE FINANCIAL SECTOR AND ILLUSTRATIONS OF THE BANK'S APPROACH

Transition Impact	Bank's Objectives	Bank's Response (illustrative)
I Structure and Extent of Financial Markets		
1.1 Competition: More competition in the financial sector	• Add to the alternative sources of financing • Use the competitive process to improve the efficiency and client orientation of financial institutions	• Support projects that promote diversity of financial institutions in a country • Conduct policy dialogue that removes barriers to competition.

1.2 Market Expansion: Availability of financial services to the real sector	• Improve availability of financing to the real sector, particularly the private sector and SMEs
	• Broaden the range of providers of financial services, including: banks, non-banks, and specialised institutions
		• Support diversification of financial services
		  • Regional institutions
		  • Non bank financial institutions
		  • Specialised institutions
		• Support banks provide finance to the real sector

II Market Support of Institutions and Policies		
2.1 Private Ownership: More widespread private ownership and entrepreneurship	• Re-structuring and privatisation of state owned financial institutions • Financing the private sector	• Focus on support for private financial institutions financing the private sector • Provide financing for SMEs and participate in the development of SME support systems
2.2 Frameworks for markets: Improved legal, regulatory and supervisory frameworks	• The development of legal, regulatory and supervisory frameworks that permit financial to operate in a market environment	• Provide support for Legal Transition to upgrade basic legislative system governing secured transactions

III Market Based Skills, Practices and Innovation		
3.1 Skills: Transfer of technology and skills	• Transfer skills, technology and capital to local financial institutions	• Work closely with strategic investors in projects where skills and technology transfer will be an integral part of the project
3.2 Demonstration effects	• Improve business, credit and risk management practices	• Work with the best financial institutions to set business standards particularly in early and intermediate transition countries, • Apply sound banking principles • Support institutional buildings particularly in early and intermediate transition countries • Projects that will facilitate the integration of the financial system into international capital markets
3.3 Standards: Enhancing standards for governance and business conduct	• Improve corporate governance • Improve the rules for business conduct • Improve transparency and standards for disclosure	• Participate actively in improving corporate governance through active participation in Boards, through policy dialogue and through public presentations • Require high standards of conduct and disclosure from clients and counterparts