DOCUMENT OF THE EUROPEAN BANK
FOR RECONSTRUCTION AND DEVELOPMENT

FINANCIAL SECTOR STRATEGY

REPORT ON THE
INVITATION TO THE PUBLIC TO COMMENT

FINANCIAL SECTOR STRATEGY

RESPONSES TO THE PUBLIC CONSULTATION PERIOD – JULY TO AUGUST 2010

The draft 2010 Financial Sector Strategy was posted for public consultation on the EBRD website from 2 July 2010 for 45 days. The public was invited to submit written comments on the draft Strategy by no later than 16 August 2010.

Comments were submitted by CEE Bankwatch Network, an international non-governmental organisation based in Prague, Czech Republic, and established in 1995 to monitor the activities of those IFIs that operate in Central and Eastern Europe.

Below are the CEE Bankwatch's key comments (*in bold*) with the Bank's response immediately beneath each comment.

Comment 1: Foreign Currency Lending
"The draft strategy outlines the EBRD's intentions to develop local currency markets in order to minimize the problems caused by loans taken by consumers and SMEs in foreign currency, and we welcome the steps taken by the EBRD so far to address this problem. However it is not clear whether the EBRD is planning to phase out support for foreign currency lending for consumers and non-exporting SMEs in countries where local currency lending is already somewhat developed, and we would ask the bank to clarify its position on this."

Response 1:
The development of viable and effective local currency markets is an important objective for EBRD. The Bank launched The Local Currency and Local Capital Markets Initiative at the 2010 Annual Meeting in Zagreb. This major initiative does not look at promoting the use of local currency in isolation, but at the overall macroeconomic, regulatory and market framework to ensure long-term, sustainable and liquid local currency markets.

The Financial Sector Strategy recognises that local currency markets will develop at different speeds and time frames across the Bank's Countries of Operation. While EBRD will be striving to improve the availability of local currency across the region, efforts are also being made to improve disclosure to borrowers about the risks associated with taking loans in foreign currency. The Bank continues to believe that a careful, balanced approach to foreign currency lending is appropriate and this entails a case-by-case evaluation of all the relevant factors. We would expect an increasing proportion of lending to be transacted in local currency lending over the coming years, but do not have an objective at the current time completely to phase out.

Comment 2: Disclosure of beneficiaries
"As we have previously stated in communication with the bank, considering the public resources dedicated to the EBRD's financial sector operations, it is unacceptable that the general public has no insight into who the final beneficiaries are of these operations or what development impacts have been attained. We are aware of and acknowledge the systemic impact of the bank's crisis interventions, however this cannot form the regular pattern of the bank's operations and with

the most urgent interventions into the banking sector already carried out, it is time to take a look beyond the banks themselves to see where this financing has ended up and what impact it has had.

We understand that there are issues of resource allocation in exactly how much information to disclose about beneficiaries, however we believe there are all kinds of possibilities available for disclosing more information than is currently the case, for example by disclosing A and B-category sub-projects, or by disclosing sub-projects over a certain value.

In addition -and in the context of the financial sector strategy -it would be possible and desirable to show which sectors and which sizes of business have benefited from sub-projects and what the average size of financing has been. In addition where renewable energy or energy efficiency is concerned it would be useful to know how many sub-projects have been financed, the average project cost, and the CO_2 emissions saved for each sub-project."

Response 2:
EBRD's financial sector projects work through financial intermediaries. While EBRD does report on the direct recipients of its financing, both debt and equity, it has taken the view that disclosure of final beneficiaries would be neither appropriate nor practical. However, it is possible to provide more information on a more systematic basis on the sectors and sizes of businesses that have been financed through sub projects. This would include financing under the Trade Facilitation Programme, MSME programmes and renewable energy and energy efficiency programmes.

This will require a significant effort in terms of amalgamating the results of diverse lending programmes, with criteria often specifically designed to reflect the economic realities of an individual country or region. However going forward it is feasible for more information to be provided as described.

Comment 3: Type of institutions targeted
"There are a few mentions of specialised microfinance institutions, however there is little information about the extent to which the EBRD has or intends to support other small-scale alternatives to banks, for example credit unions or building societies and whether the EBRD considers such models feasible in the region. We would ask the bank to add information on small-scale alternatives to banks in the region and whether it intends to support the development of such models."

Response 3:
EBRD uses a range of financial intermediaries to provide access to credit for small business entrepreneurs, including commercial banks which are active with smaller borrowers as well as specialised Micro Finance Banks (MFBs) and Non-Bank Micro Finance Institutions (NBMFIs). To date EBRD has worked with 18 MFBs for a total cumulative volume of EUR 338 million and with 37 NBMFIs for total cumulative volume of EUR 132 million. EBRD is also exploring new relationships with credit unions and cooperative banks as additional mechanisms to reach smaller borrowers and to support the use of 'best practice' cooperative bank procedures and structures. In several of the Bank's countries of operations the cooperative banking network has emerged as an alternative to private commercial banks with members as owners and

borrowers. While these structures present particular challenges, the Bank is exploring ways of providing technical support alongside its funding to facilitate the long-term sustainability of the sector. We will include additional wording in the strategy document.

Comment 4: Offshore Financial Centres

"During the past year the EBRD has been requested by some key shareholding companies such as France and Germany to tackle the issue of financing which is channelled through offshore financial centres, also known as secrecy jurisdictions or tax havens. We understand from discussions with bank staff that the EBRD is awaiting the results of the OECD's work on this issue before adopting a full policy, however in the interim we would ask the bank to insert an addition into its financial sector strategy stating the extent to which offshore financial centres are an issue affecting the bank's operations in the financial sector and how it plans to address this during the coming strategy period."

Response 4:

The concerns raised by CEE Bankwatch in respect of offshore financial centres have been addressed comprehensively in the Bank's new policy on "Offshore Jurisdictions in EBRD Projects", approved by Board on 20 July 2010. Pursuant to that policy, the Bank takes full account of the determinations made by the OECD Global Forum on Transparency and Exchange of Information and by the Financial Action Task Force. The policy applies to all EBRD lending and investment operations for entities that are domiciled in a jurisdiction different from the country where the project is located, or that are controlled by entities domiciled in such a jurisdiction.

Comment 5: Gender Impacts

"There is not a word in this strategy regarding the gender-specific impacts of the EBRD's financial sector operations and how the bank intends to ensure that negative impacts are minimised while the benefits are shared between men and women. We ask the bank to make additions regarding the gender impact of its financial operations. If it currently has no information about this then we recommend that it states what it will do to assess the impacts."

Response 5:

The final version of the strategy document includes text on EBRD's approach to gender impacts and gender issues. There are specific gender equality references used in regard to corporate governance standards, board representation and supporting small business development.

Comment 6: Affordability of loans
"On p.29 the strategy states that "At the same time, the cost of finance has increased, thus pricing some smaller borrowers out of the market, although it should be noted that reliable access to funding is often of more concern to MSMEs than the cost of funds." Naturally it is hard to be concerned about the cost of loans if there are none available at all, however we believe that the cost of loans is nevertheless very important for MSMEs. We ask the bank to make clear how it ensures that the cost of financing through its financial intermediaries is not too high and how it assesses what constitutes "too high"."

Response 6:
EBRD supports competition in the provision of finance and makes every effort to ensure that its MSME products are provided through a number of competing Partner Institutions. It has been EBRD's experience that competition and fair disclosure of effective borrowing rates creates the conditions that promote and encourage progressively lower interest rates and margins on a sustainable basis. In markets where interest rate caps have been applied in an artificial or administrative manner, commercial providers of credit subsequently withdraw from the market and access to affordable credit by small borrowers is curtailed.

Interest rates also reflect local conditions. The cost of funds will vary according to inflation expectations and liquidity conditions in the market. These are ultimately affected by the macro-economic and financial policies of the country. As such there are no recipes for determining what would constitute "too high", but the Bank is aware, through its presence in the region and close interaction with the financial sector, of the general environment for pricing and seeks to work only with partners that have sustainable business models for reaching the target market.

Comment 7: Support for retail lending
"p. 29 of the draft strategy states that the EBRD aims to "Provide continued support for retail lending, including mortgages and consumer finance, provided they are undertaken on a suitably prudent basis, follow best practice standards and reflect an assessment of the prevailing regulatory environment." How does the EBRD define 'a suitably prudent basis' and where is the list of best practice standards outlined?"

Response 7:
"Prudent lending" and "best practice standards" refer to the criteria that lenders apply in their lending activity and the manner in which they interact with their clients. For example, EBRD expects their partner financial institutions to apply prudent loan to value ratios when issuing mortgages. The Bank has in fact published its own Mortgage Loan Minimum Standards Manual specifically to assist financial institutions with mortgage lending best practice. For the full range of retail loans, EBRD expects its partner institutions to disclose the full costs of borrowing and to ensure that their clients are aware of the risks that they face, including the risks associated with foreign currency loans.

Comment 8: Transition and the role of private equity
"The priorities to achieve transition impact in the financial sector have been reoriented in the context of the current economic and financial crises, as the draft

Strategy notes and the second Transition Impact Retrospective elaborates. The draft Strategy acknowledges that an improved regulatory environment is an important lesson learned from these crises that will enable transition impact in the financial sector.

We believe that, in addition to strengthening institutional aspects of the financial sector like corporate governance, regulation and risk management, any successful measure of achieving financial sector transition must necessarily account for the social well being of the public in the bank's region of operations. We are therefore concerned that, in the primacy the EBRD places on the development of the private equity industry in the region to achieve transition impact, there is no mention of the social implications of this sector's activities.

With private equity's focus on the quick resale of target companies to maximize short-term returns, evidence of the negative impacts on employment and the workforce has been documented. A report of the 2008 World Economic Forum1 notes that job losses tend to be more significant in the leveraged buy-out activities of private equity firms, with workers in target companies experiencing higher tolls of unemployment.

Similarly as the management culture of private equity is well-known for cutting costs in all possible instances to maximize returns and increase the industry's allure for generating huge profits, pressure on wages, benefits and working conditions, refusal to engage in collective bargaining, and outright harassment of workers who organise in trade unions have been some of the results. We therefore ask the EBRD to elaborate in the draft strategy how its focus on the development of private equity as a contributor to achieving transition impact will ensure that solid industrial relations are maintained and workers' rights are upheld.

WEF (2008) 'The global economic impact of private equity report2008, Globalization of alternative investments', Working Papers,
Vol. 1. http://www.weforum.org/pdf/cgi/pe/Full_Report.pdf"

Response 8:
According to EBRD's Environmental and Social Policy Performance Requirement 2, *Labour and Working Conditions of EBRD Performance Requirements*, "EBRD believes that for any business, the workforce is a valuable asset, and that good human resources management and a sound worker-management relationship based on respect for workers' rights, including freedom of association and right to collective bargaining, are key ingredients to the sustainability of the enterprise. By treating workers fairly and providing them with safe and healthy working conditions, clients may create tangible benefits, such as enhancement of the efficiency and productivity of their operations".

To that extent, all venture capital and private equity funds managers with whom EBRD currently invests are required to adhere to best practice international standards, applicable laws and to EBRD's Environmental and Social Policy Performance Requirements with respect to labour relations and workers' rights. Specifically, according to the above cited Performance Requirement 2, projects (including equity fund projects) are required to comply, at a minimum, with:

- national labour, social security and occupational health and safety laws, and
- the principles and standards embodied in the ILO conventions[1] related to:
  a) the abolition of child labour
  b) the elimination of forced labour
  c) the elimination of discrimination related to employment
  d) the freedom of association and collective bargaining.

Compliance with and implementation of such standards is actively monitored by the Bank through the equity fund life cycle.

The Bank notes that the Report of the 2008 World Economic Forum cited by CEE Bankwatch is focussed on investments "that involve leveraged buyouts or other equity investments with a substantial amount of associated indebtedness (as opposed, for instance, to venture capital investments in start-ups)". However, like venture capital investments, the Bank's equity funds activities have been substantially focussed on the provision of growth and expansion capital primarily to small and medium sized businesses in its countries of operation, and not with managers focussed on the short term resale of mature target companies.

Comment 9: Environmental and social impacts of Trade Facilitation transactions
"At this year's annual meeting the issue of assessing the environmental and social impacts of Trade Facilitation transactions was raised, and it was stated that the Evaluation Department's report was being awaited, and then the Environment and Sustainability Department would look at ways to ensure that the risks were being properly assessed. It would therefore be useful if this strategy included information about which sectors have been and will be supported by the bank's trade facilitation transactions, and whether any changes have been or are likely to be made as a result of the Evaluation Department's findings."

Response 9:
Following the receipt of the Evaluation Department's report on the Trade Facilitation Programme, EBRD has decided to undertake a full review of the Programme to ensure that its objectives are relevant to the current situation in the region and the clients' needs, and that its activities are fully consistent with EBRD's mandate. The review will include processes that address issues such as risk assessment and compliance.

[1] ILO conventions 29 and 105 (forced and bonded labour), 87 (freedom of association), 98 (right to collective bargaining), 100 and 111 (discrimination), 138 (minimum age) 182 (worst forms of child labour).