European Bank for Reconstruction and Development (EBRD)

FY2005 Appropriation	FY2006 Scheduled Request	FY2006 Arrears Request	FY2006 Total Request
$35,147,662	$290,452	$725,225	$1,015,677

For FY2006, the Administration requests appropriations of $290,452 for scheduled contributions of paid-in capital for the capital increase of the European Bank for Reconstruction and Development (EBRD) and $725,225 for arrears on past paid-in capital obligations. The $1,015,677 appropriation request would complete U.S. payments for the capital increase.

The EBRD was created in 1991 to promote private sector development, foreign investment, privatization, and efficient financial markets in Central and Eastern Europe and the former Soviet Union. Borrowing countries are expected to be "committed to and applying the principles of multiparty democracy, pluralism, and market economics." The Bank also has a mandate to promote environmentally sound and sustainable development.

Key Facts

- The U.S. is the single largest shareholder in the EBRD with a 10% share.

- Since its inception, the EBRD has financed approximately $35 billion in loans and equity investments, contributing to investments in the region worth over $105 billion. In 2004, the EBRD committed $5.6 billion in new projects and disbursed $5.3 billion.[1]

- The EBRD's focus on private sector development continues: 71% of its portfolio (and 89% of new business in the first nine months of 2004) consist of private sector projects, well over the Charter requirement of 60%. EBRD develops the private sector though loans and equity investments in private businesses and by mobilizing private capital alongside its own resources.

- The EBRD also provides loans for projects in the public sector, with and without sovereign guarantees, to promote development of market-oriented economies through commercialization and/or privatization of state-owned enterprises and public utilities or the restructuring of municipal services. EBRD pursues these objectives through project finance operations (rather than budget support to governments), ensuring that the client's revenues can service debt and provide a return on investments made.

[1] Results reported as of 12/31/04. Based on US$1.365 / €1.00 exchange rate at that time.
Note: EBRD Fiscal Year: January 1 – December 31. Internet website: www.ebrd.com

Supporting U.S. Objectives

Managing for Results

The EBRD has been profitable in all but one year since 1995 and has, over the past decade, expanded business volume while slightly reducing its operating budget in inflation-adjusted terms.

For each of its countries of operation, the EBRD monitors progress in transitioning toward a market economy. Specifically, the EBRD produces an annual Transition Report that examines policy changes and economic developments in each country and a semi-annual publication entitled Law in Transition, which examines the quality of laws and institutions (such as insolvency laws, corporate governance, and contract enforcement) that build market-based economies, create a sound investment climate, and promote economic growth.

In evaluating a project, the EBRD carefully considers its transition impact as well as its commercial viability. The transition impact results from aspects of the project that facilitate the country's transition toward a well-functioning, dynamic market economy. Examples are: improvements to a company's corporate governance practices, commercial restructuring of inefficient state-owned enterprises, adoption of more up-to-date production methods (frequently assisted by a foreign investor), development of the local financial sector, and expanded access to financing for microenterprises and SMEs.

In the preparation of each project, the EBRD rates the project's transition potential and measures the risk that the potential will not be reached. During this process, any project that fails to achieve at least a "satisfactory" transition impact rating is rejected. In the past several years, more than 80% of proposed project have exceeded this minimum rating and have achieved ratings of "good" or "excellent".

Subsequently, the EBRD monitors the achievement of the potential transition impact both during project implementation and after project completion. For the implementation stage, the EBRD recently developed the Transition Impact Monitoring System (TIMS). Because the system is new, the EBRD has not yet been able to develop an assessment of all 491projects currently in the implementation stage. However, for the 413 projects that the Bank has evaluated under TIMS, 311 projects (75%) currently have a "good" or "excellent".

The EBRD also regularly conducts ex-post evaluations of projects for their success in achieving transition impact, improving the environment, and maintaining sound investment principles. With respect to the key indicator of transition impact, 240 completed projects have been evaluated since a new rating scale was introduced in 2000. Of these projects, 57% earned ex-post transition impact ratings of "good" or "excellent". Of these 240 projects, 92 projects were initiated after the ex-ante ratings system was developed and thus have both ex-ante and ex-post ratings. In this subset, 61 of the projects (66 percent) received ex-ante ratings of "good" or better, while 62 projects (67 percent) received ex-post ratings of "good" or better.

The environmental findings of these evaluations are discussed in the "Environment and Energy Efficiency" section below.

In order to ensure that these evaluations improve future operations, the EBRD's Project Evaluation Department has created a substantial database of operations assessments setting forth "lessons learned" for EBRD staff. The EBRD also maintains a section on its web site for its evaluation activities, including examples of successful and less successful projects, and in-depth studies on particular areas of operation. The U.S. carefully reviews projects with a focus on demonstrating that EBRD financing will maximize economic transition and contribute true "additionality" by providing financing generally unavailable from the private sector.

Increasing Productivity

The EBRD's core mission is to facilitate the transition toward market economies. Toward that end, over 70 percent of EBRD's operations are for the private sector, and the EBRD's public sector projects are also aimed at commercializing or privatizing publicly run activities. EBRD projects improve productivity in the EBRD's countries of operations by transferring technology and management know-how and upgrading workers' skills. Successful projects also have a "demonstration effect", which leads other private firms to invest and continue the process of building physical and human capital in countries of operations.

The EBRD invests in a range of sectors, including agriculture, banking, telecommunications, and energy, among others. Among the projects approved by the Board in 2004 are:

- A public transport project in Krakow, Poland, designed to commercialize the provision of transport services, in part by contracting out a portion of services to private sector providers.

- A loan and equity investment for a dairy processing company in Azerbaijan to enable the company to construct a new dairy plant in Baku, and to improve its milk collection infrastructure.

- A project in Kazakhstan to expand financing for private farmers, agribusinesses, and traders so that they might purchase or lease agricultural equipment (mainly for grain seeding and harvesting purposes) to replace the fleet of mostly Soviet-made and already outdated machinery.

- An equity investment in a bank operating in the Siberia region of Russia so that it might pursue a strategy of business expansion, thus expanding access to capital for entrepreneurs in an region of Russia where such financing is scarce.

- A loan to enable a cement company in Albania to restructure its operations and build a new cement production line.

Promoting Market-Oriented Reforms

The core mission of the EBRD is to create market-oriented economies in Central and Eastern Europe and the former Soviet Union. The EBRD pursues this goal through its investment operations, technical cooperation, analytical work, and policy dialogue.

- Investments: As noted previously, the EBRD finances only projects (as opposed to budget or balance of payments support). The majority (over 70 percent) of EBRD's operations are providing loans, equity investments, or guarantees for privately owned businesses in order to support their expansion and/or modernization or to facilitate the creation of new enterprises by local or foreign investors.

- Technical Cooperation: One of the EBRD's important contributions, in addition to financing, is its donor-funded technical assistance, through which consultants help clients to streamline their operations or assist clients in areas such as feasibility studies, staff training, or procurement.

- Analytical Work: The EBRD's ability to bring private investors into the region depends on a country's investment climate and policy framework. Toward this end, the EBRD routinely performs analytical work to better inform itself, member governments, and investors. Among other publications, the Bank produces an Annual Transition Report every autumn (as well as an update every spring) that reports on each country's policy environment. In addition, the EBRD has worked with the World Bank to conduct the Business Environment and Enterprise Performance Survey (BEEPS), which compiled the experiences of more than 10,000 firms in 26 transition countries in 1999 and 2002. Another survey is currently being planned.

- Policy Dialogue: In order to encourage governments to act on problems identified in the Bank's analytical work, EBRD staff also engage in policy dialogues with the authorities in its countries of operation. These dialogues may relate broadly to necessary improvements in investment climates or more specifically to reform of regulatory frameworks for a certain sector, such as energy or transportation.

Micro, Small, and Medium-Size Enterprise Development

In July 2000, the U.S. Treasury established the US-EBRD SME Financing Facility at the EBRD to support SME financing through technical assistance to local financial institutions and credit lines for on-lending to SMEs. The focus of the Facility is micro and small enterprises, though 20 percent of the funding is available to medium-sized enterprises.

The Facility is to support three main activities: (1) debt finance to SMEs by on-lending through eligible banks; (2) technical assistance to train credit analysts and promote sound business practices and good governance at participating banks; and (3) technical assistance to identify legal, regulatory and policy impediments to improve the operating environment for SMEs.

As of end-November 2004, the U.S. has paid $37.9 million (of a $50 million U.S. commitment) into the Facility. These contributions have leveraged total loan volume of approximately $2.4 billion with 425,000 loans disbursed in 13 countries with an average loan size of just over $5,700. The Facility initially operated only in South-East Europe, but beginning in mid-2002 began to expand into the former Soviet Union. The EBRD matches these funds with its own loans or equity investments. The EBRD has agreed to commit $100 million of its own funds for the facility.

The EBRD, at the request of the U.S. and other donors, also established in 1994 the Russian Small Business Fund (RSBF) in order to provide technical assistance and loan funds to Russian banks for micro, small and medium enterprise lending. The initial agreement provided the RSBF with $300 million, divided equally between the Bank and donors (the G-7 and Switzerland). In 2001, the EBRD committed to provide an additional $150 million, $50 million of which was contingent upon a commitment of $30 million in new funds from donors, bringing the potential fund size to $480 million. The U.S. has contributed a total of $42 million. RSBF has been successful in reaching businesses and generating on-lending. As of end-November 2004, the RSBF had disbursed 220,000 loans in the amount of $1.8 billion to micro and small enterprises in 133 towns and cities across Russia.

Promoting Democracy

Article 1 of the EBRD Articles of Agreement states that the EBRD is to foster economic transition in those countries in the region that are "committed to and applying the principles of multi-party democracy, pluralism and market economics." The EBRD may limit a country's access to EBRD financing if that country is implementing policies that are inconsistent with Article 1. In 2002, with U.S. support and leadership, the Board approved country strategies for Belarus and Turkmenistan with graduated lending levels, which limited EBRD financing narrowly to the private sector and tied any increase in investment to specific improvements in meeting these Article 1 requirements. In March 2004, the Board of Directors noted Uzbekistan's failure to make progress in terms of political and economic benchmarks identified a year earlier, and subsequently restricted future EBRD operations to private sector projects or municipal projects that meet basic human needs.

Improving Governance and Combating Corruption in Countries of Operation

The EBRD, like the IFC, has less direct influence on recipient countries' governance than the other MDBs because it focuses primarily on investments in the private sector (about 72% of its cumulative lending since 1991). The EBRD does not provide program or structural adjustment lending to governments, this limits EBRD's ability to directly influence a given country's economic policies.

Nevertheless, as an international institution with the mandate to assist the countries whose economies are in transition, the EBRD views the promotion of good corporate governance as important to its work. In its projects, the EBRD limits the scope for corruption through, among other things, its integrity due diligence with respect to the individuals and entities involved, its requirement that accounting practices be in accordance with international standards, and close monitoring of projects post-disbursement. Where the EBRD takes an equity stake, it frequently sits on management and supervisory boards to add direct governance and oversight. In addition, each EBRD country strategy contains a candid discussion and assessment of corruption and governance, and includes an extensive political annex that is made public.

The EBRD provides input to *Business Principles for Countering Bribery*, which were developed and published by Transparency International and Social Accountability International with input from NGOs, companies, academia, and trade unions. The EBRD's Chief Compliance Officer plans to help disseminate these principles through her work.

In addition, the EBRD develops and uses diagnostics and indicators to identify problems:

- Through its *Corporate Governance Assessment Project*, the EBRD rates countries on the basis of (i) protection of shareholders' rights and (ii) equitable treatment of shareholders (i.e., minority shareholders). Corporate governance codes now exist in seven EBRD countries, and three more were in the process of being drafted at the end of 2003. Nine countries are rated as being in high compliance in terms of a corporate governance system, measured against the *OECD Principles of Corporate Governance* which uses the indicators noted above. Ten EBRD countries are in medium compliance, four are in low compliance, and four are in very low compliance. These results can be found on the EBRD's public website (www.ebrd.com).

- As noted above ("Promoting Market-Oriented Reforms"), the EBRD has done two rounds of BEEPS, or business environment surveys, in its region, and is planning to do an updated survey. The surveys show that the business environment has improved significantly across most EBRD countries of operation since 1999. Some of the strongest improvements in economic governance have been in the less advanced economies in Southeastern Europe and the Commonwealth of Independent States.

- The EBRD is also working with the Foreign Investment Advisory Service (FIAS) of the World Bank and IFC in surveying businesses on the administrative barriers to investment in EBRD's countries of operation. The surveys include questions on corruption and bureaucratic obstacles to setting up and running a business, and are followed by Action Plans developed by FIAS for use by government officials to reduce administrative barriers and improve the investment climate. The EBRD has engaged in several joint projects on administrative barriers to investment in Kazakhstan, Georgia, and Russia (in Perm, Kaliningrad, and Sakhalin). An assessment of administrative procedures in Georgia has just been completed, and an Action Plan is intended for the next phase.

- The Bank's Legal Transition Program aims to improve the legal environment of the Bank's countries of operation. This program is fostering interest in and helping to define and implement legal reform in various sectors (e.g., capital markets, corporate governance, concessions, bankruptcy, secured transactions, and telecommunications regulation) through the provision of legal technical assistance and policy and strategy advice focused on the development of the legal rules, institutions and culture necessary to reduce corruption and support a vibrant market-oriented economy. The EBRD also produces a survey analyzing secured transactions laws in its countries of operations.

Examples of the EBRD's governance and anti-corruption work in particular countries include the following:

- A $13 million loan to a state-owned telecommunications operator in Tajikistan to improve access to and the quality of basic telecommunications services. The project involved a new telecommunications law and more transparent licensing.

- A $26 million loan to a tire manufacturer in Russia, which will involve, among other things, appointment of two independent directors to the board, establishment of an audit committee of the board, and protection of minority shareholder rights.

- A $6 million debt and equity investment in an Azeri dairy processing company that will include, among other things, appointment of international auditors to audit the company's accounts according to the IFRS and appointment of independent directors to the board.

- Ongoing work to promote insolvency law reform in Georgia, which is expected to include the training of judges and insolvency practitioners. A top priority will be to address corruption issues in dealing with insolvency matters.

- The Hungarian government has requested EBRD's assistance in the preparation of a new Hungarian insolvency law. The EBRD expects that proposed reforms will help address concerns regarding corruption in the handling of insolvency cases.

Improving Corporate Governance and Implementing Internal Controls within the EBRD

The U.S. Director has played an active role in promoting the adoption of best practices with respect to corporate governance and internal controls in the EBRD, and there has been notable success in the past year.

- In April, the Board approved a revised Terms of Reference for the Board's Audit Committee. This revision strengthens the Board's role in financial oversight over the EBRD and, more specifically, has gained greater independence for three core functions – internal audit, project evaluation, and compliance – by increasing the Board's role in the hiring and firing of the heads of these departments.

- EBRD Management has agreed to implement a system for certification of internal controls, in line with international best practice. This system will result in a management assertion letter with respect to the effectiveness of internal controls over external financial reporting and an attestation by the external auditor regarding the process and adequacy of documentation to support management's assertion. This will be done for the 2004 financial statements. The assertion and attestation letters will be published in the EBRD's 2004 Annual Report. In addition to this process, the EBRD is establishing a self-assessment process to identify and mitigate the EBRD's exposure to operational risk.

Improving Information Disclosure

The U.S. Director's office has consistently advocated for greater public disclosure of information on the EBRD's policies and operations. While there have been some positive changes, the institution is still not as transparent as it needs to be.

In April 2003, the EBRD reviewed its public information policy (PIP). While welcoming the revisions to the PIP as a step forward, the U.S. voted against the revised policy, which remained inadequate.

Positive changes include:

- More project evaluation documents available to the public;
- Solicitation of public input on country strategies;
- Translations of new country strategies into local languages.

The U.S. will continue to work with other chairs toward achieving:

- A 120-day public disclosure period for environmental assessments for all projects with significant environmental impacts (the current policy requires only 60 days for private sector projects);
- Release of minutes of Board of Directors meetings;
- Release of all policy and strategy documents and public sector loan proposals prior to Board consideration;
- Posting on the website of the EBRD an annual report containing statistical summaries and case studies of the fraud and corruption cases pursued by its investigations unit; and
- Posting on the website of the EBRD the findings of its transition impact monitoring system.

Improving Borrowers' Fiscal Transparency

The EBRD invests primarily in private sector companies or projects, and its operations with governments are limited to projects with state-owned entities. Therefore, the EBRD can improve the fiscal transparency of governments in two ways:

- *Requiring that government revenues and expenditures associated with extractive industries occur in a transparent and accountable manner.* For example, in the context of recent oil and gas projects in the Caucasus, the government of Azerbaijan established an oil fund to receive revenues, will hire an internationally recognized auditing firm to perform audits, and will make the results of the audits publicly available.

- *Promoting the proper framework for the delivery of municipal services.* In its municipal projects, the EBRD frequently restructures the delivery of services, focusing the local government on establishing basic principles and contracting services with a private provider through an arms-length, competitive process, rather than providing public services directly.

This change reduces the possibilities for nontransparent subsidies of local government service providers.

Combating Terrorism

The EBRD has expressed a clear commitment to support efforts to combat terrorism and is cooperating with the U.S. and the UN in that regard. The EBRD has established the appropriate due diligence procedures to ensure that its resources do not inadvertently support terrorist organizations. Staff has been receiving mandatory training, managed by the Chief Compliance Officer, on anti-money laundering procedures. The EBRD also follows the work of the Financial Action Task Force, the international body which oversees the fight against money laundering and financing of terrorists.

Improving the Environment and Promoting Energy Efficiency

Under its environmental policy, the EBRD promotes "environmentally sound and sustainable development". This policy requires, among other things, compliance with applicable regulatory requirements, attention to mitigation measures, and consideration of social issues (e.g., rights of indigenous people and workers). Environmental assessments and public consultation are required for all environmentally sensitive projects, and Country Strategies also include a review of local environmental issues. Nearly all new projects are subject to the application of European Union and/or World Bank environmental standards. In fact, meeting these standards is often built into the project objectives.

- For example, the EBRD provided a €11.5m loan to a municipal water company in Bulgaria to enable the company to implement a €38.8 million program of water and waste water infrastructure modernization. The loan will help the city to comply with EU environmental directives and reduce pollution of the Black Sea while accommodating the anticipated continued growth of tourism and other economic activity.

As this example demonstrates, the EBRD works extensively to improve environmental conditions in the municipal sector, frequently for water supply and water-wastewater treatment.

- In another project, the EBRD provided a €20m loan to a municipal water and wastewater management company in Ukraine to support substantial improvements in water and wastewater infrastructure and services. The project is expected to contribute to a long-term sustainable reduction of the pollution load of the Dnipro River and the Black Sea basin. The project is expected to provide an important demonstration effect for other cities in the country.

The EBRD also works to improve energy efficiency throughout its countries of operation both through its regular investments and through targeted investments in the energy sector.

- The EBRD made a €37.3m equity investment to facilitate the privatization of a Polish cogeneration and district heating company. The project was designed to improve the energy and operational efficiency of the company.

Nuclear Safety

The EBRD engages in several activities to promote nuclear safety:

- The EBRD manages the Nuclear Safety Account (NSA) on behalf of the United States and other donor countries. The NSA provides grants to perform short-term safety improvements to the most dangerous reactors in the region. These grants are linked with a commitment to their early closure.

- Since 1997, the EBRD has managed the donor-funded Chernobyl Shelter Fund. This fund, which began issuing contracts in 1998, is assisting in providing a new and safe sarcophagus for the damaged Chernobyl nuclear reactors. The sarcophagus is scheduled for completion in 2007. The last operating reactor at Chernobyl was closed in December 2000.

- Aside from these accounts, the EBRD also funds projects with other donors to promote nuclear reactor safety. For example, in the past year, EBRD loaned $42 million (along side $83 million from the European Commission) to Ukraine's state-owned nuclear power generation company to complete a safety modernization program for the Khmelnitsky 2 and Rovno 4 nuclear power reactors, bringing these units into compliance with international safety standards.

Opportunities for U.S. Business

In 2003, EBRD operations produced $190.32 million in business benefits to the U.S., of which $174.73 million was for U.S. company-sponsored projects approved by the EBRD, $9.89 million was in contracts on public sector projects, and $5.7 million was in EBRD consulting contracts.