1. A New President Takes the Helm

The EBRD’s second President, Jacques de Larosière, came to the Bank with an impeccable pedigree. He had served four years as Director of the French Trésor in the 1970s before being appointed to head up the IMF in 1978. After two successful terms at the Fund, de Larosière moved back to Paris in 1987 to take charge of the Banque de France.¹ His time there coincided with a succession of currency crises as the ERM, the precursor to monetary union, came under speculative attack. After six years in the role, the EBRD presented a challenge of a different kind. “When I arrived in Bishopsgate, London alone ... one day in October 1993, I found a bank in complete disarray,” de Larosière wrote later, “the public perception of the EBRD needed to be changed completely and immediately.”²

EBRD staff were anxiously awaiting the arrival of the new President. After the period of internal confusion, the media storm and Attali’s abrupt departure, bankers did not know quite what to expect of their new boss. He did not keep them guessing for long. On his first day at the Bank, de Larosièrè addressed a full staff meeting in the auditorium. According to one witness:

His opening salvo was along the following lines: “To those of you in this room who believe that the issues of this Bank are limited to its marble, let me tell you they aren’t. There are three main issues confronting the organisation: a lack of strategy; resources out of control; a terrible public image”³.

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¹ De Larosière swapped roles with Michel Camdessus.
² J. de Larosière, 50 Years of Financial Crises, Odile Jacob, 2018, pp. 174–175.
³ Interview with senior EBRD official.
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On the same day, he signalled his intent by ordering the closure of the Bank’s gourmet restaurant and abandoning the huge presidential office “to join my colleagues in rooms similar to their own”.

More substantive cost-cutting measures followed. At the initial meeting of all Bank staff, de Larosière announced that flights would henceforth be reimbursed only at economy rates, hiring would be frozen and some redundancies would be made. Office space would be freed up to allow the subletting of some floors and provide savings on the expensive rent. Salary increases would be held back and managed within a “zero growth” budget for the following year (despite an expected increase in the volume of business) and Attali’s cabinet—and with it its “political activities”—would be wound up.

2. Reorganisation

A tough approach to managing costs was not the only measure de Larosière took to restore the Bank to a more even keel. Even more important was a reorganisation and simplification of the management structure.

The existing structure had serious weaknesses that had become more evident as business developed. A key area of concern was the dual system whereby public-sector bankers operated independently of private-sector bankers, each seeking to build their own portfolios. An organising principle was needed that would allow them to work together. De Larosière saw this as being the country context, no doubt influenced by his years at the IMF where individual country programmes were run by mission chiefs, supported by specialist teams covering areas such as tax administration or monetary arrangements.

The IMF model could not be lifted wholesale for a project-based institution such as the EBRD, but a country-led approach, focused on clients’ needs, could help to align the operations of the public and private-sector sides. The goal was to create good deals without reliance on ‘soft’ money or sovereign guarantees. Sector teams were also rearranged on regional lines. A North- 

4 The abolition of the divide between private and public sector teams forced a convergence of thinking and appreciation of different approaches. As a result, projects were more easily facilitated through private sector structures and financial instruments combined with technical advice and policy dialogue.
South divide was adopted initially, with responsibility for the regions assigned to Ron Freeman and Mario Sarcinelli, respectively. Russia was allocated to the North, and the Caucasus and Central Asia to the South.

Sarcinelli subsequently left the EBRD in April 1994, and the Banking Department was consolidated under Freeman as sole First Vice President (FVP). The FVP was fully in charge of the Banking Department, chaired OpsCom and was the senior executive responsible to the Board for operational activities. Three deputies and a similar number of advisers formed the FVP’s front office. The rest of the FVP’s office essentially looked after the running of the Department. As a mark of the importance of operational business, and deal-making in particular, the country and sector team leaders reported directly to the FVP. All projects needed dual sign-offs by the relevant country and sector team leaders, improving coordination and understanding between banking teams.

First announced in November 1993, the country focus and flat matrix organisation—with sector teams providing transactional expertise while country teams fronted the handling of the authorities and government contacts—had bedded in when Freeman reported on the new structure to the Board in May 1994. In essence, the changes made then have lasted to the present day.

At the apex of the project decision-making process was OpsCom. The project cycle started with exploratory transactions at the operation-leader level which, if agreed with their team director, would then move to the concept stage. This required a written memorandum and appraisal for OpsCom, whose members included a full range of senior departmental representatives. If a project passed Concept Review it would progress to a Structure Review and then Final Review before being sent to the Board for approval. The fact of Board approval was no guarantee of a project’s signing, which depended on the client and often the speed with which the project was processed through the internal cycle of approval.

OpsCom included senior lawyers and risk managers, in line with established practice in commercial banks. Membership was extended to the EBRD’s Chief Economist to ensure that each project achieved transition impact and complied with the notion of additionality. Representatives of

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the environmental department also attended. Freeman ensured every interested party was represented around the table:

The key to success was to get every constituency involved in ensuring the various criteria which the Articles set forth were present in each project. So I made it a collegial, open forum in which every constituency was equal. Everyone had a vote. Unless we had unanimity a project wouldn’t pass [though] we’d try to fix what was missing. We ran it openly and collegially and on an equal basis. People recognised that and responded to it, as people do when treated respectfully. That basically carried forward.6

Intense scrutiny was applied at the concept stage to wean out dud transactions and offer clear guidance on how to structure projects. Early scrutiny also provided clients with clarity on what was needed for the project to go forward. This contrasted with other development finance institutions (DFIs), where the announcement of new requirements in the end stages of a transaction (reflecting late interventions by senior officials) caused clients significant problems. The EBRD was not immune to this, particularly in bigger and more contentious cases, but in general the early input of senior management helped to smooth the process. Bankers’ presence on the ground, and their readiness to listen and adjust to local circumstances, was another positive factor. As a result, clients’ confidence in dealing with the Bank grew.

Another advantage of the arrangements was that it was open and gave junior staff members direct access to the FVP. At this point, relatively few deals were going through the system so they all went to OpsCom, which would discuss three or four projects a week at the regular Friday morning slot. Junior bankers gained exposure to the thinking at the top, either through having to defend their projects in front of the Committee or by attending sessions where similar or related operations were being scrutinised. This provided a vital training ground on how to develop and manage transactions. It was also good preparation for cross-examination by the Board.

Freeman and de Larosière were perfect complements for one another in their different roles and got on extremely well. As a Salomon-trained US banker with a legal background,7 Freeman was an ideal foil for the experi-

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6 Conversation with the author.
7 Freeman was a graduate of Columbia Law School and a member of the New York State bar.
enced French international finance manager and civil servant. It helped that Freeman’s mother was French and he had spent several years working in Paris. He preferred to converse with de Larosière in French.

A consummate manager, de Larosière also took care to ensure that the roles and responsibilities of the Bank’s senior executives were clear and distinct. He saw no reason to interfere with the management of the Bank’s operations when it was in the hands of someone with obvious capability in that field who commanded the respect of his staff. The EBRD was a bank with a focus on the private sector and earnings, and Freeman was the top executive of the banking division. This meant de Larosière was able to focus on running the organisation and acting as Chairman of the Board. (Formally, the President of the EBRD is both in charge of the management and chairs the Board.) In particular, it left him free to drive the strategic direction of the Bank and secure its proper place in the international arena among other IFIs.

3. The Task Force on Operational Priorities

Shortly after taking up office, in the autumn of 1993, the new President announced the creation of a Task Force to determine the operational priorities of the Bank. De Larosière wanted to carry on his predecessor’s efforts to foster change in the East but within a more precise strategic purview. The remit given to the Task Force was quite broad and included the suggestion of soliciting the views of stakeholders to gain an inclusive assessment of the future direction of the Bank. This turned out to be the start of a more formal series of planning exercises which lasted well beyond de Larosière’s time as President.

The Task Force was led by Nick Stern, whose appointment as EBRD’s Chief Economist,8 was announced in June 1993, in anticipation of Fleming’s departure to Wadham College, Oxford, and following Michael Bruno’s decision to move to the World Bank.9 The objective was to generate a clearer focus for the EBRD and lay the grounds for a medium-term strate-

8 See the list of current and past EBRD Chief Economists at: https://www.ebrd.com/who-we-are/senior-management/beata-javorcik.
9 Bruno was appointed Chief Economist in March 1993 to take up the position in October that year, but he did not do so. Stern acted in an advisory capacity before taking up his appointment as EBRD Chief Economist formally in early 1994.
The setting, as the Report put it, was to ensure that the Bank’s priorities matched the process of growth and transition, and leveraged its comparative advantage relative to private-sector financial institutions and other IFIs. It involved a rapid but comprehensive assessment of the views of stakeholders in the Bank’s business, from bankers and clients to shareholders and other IFIs. Some 250 people were interviewed within a month and a half and the Task Force submitted its report to the President in mid-December 1993.

The Board and IFI interviewees believed that the first priority of the Bank, and its comparative advantage, was the development of a competitive private sector. The EBRD’s ability to participate in private-sector projects was not something the World Bank or the EIB were designed for, and the IFC, while similar to the EBRD in this respect, was not very visible in central and eastern Europe. Further advantages of the EBRD were its relatively fast and flexible processes, its ability to combine policy work with projects (“having the IBRD and IFC under one roof”), and the range of instruments at its disposal.

The Board also added some important insights which the Task Force included in its final Report. One was that the Bank should ensure that support was provided to all of its countries of operations. More than half of Board-approved projects to that point had been in just three countries: Hungary, Poland and Russia. Adding the Czech Republic and Romania brought this up to three-quarters of the total. The Bank still had no signed commitments in seven of its 25 countries of operations, and no private-sector signings in a further three.

Second, the EBRD should be seen as a wholesale rather than a retail organisation. This meant working much more through financial intermediaries instead of via direct investments, particularly in trying to reach SMEs. The SMEs were viewed as the backbone of a successful market economy and needed help which could be best leveraged by deploying Bank funds through intermediaries.

Third, there was a desire to see an increased use of equity, which at that point comprised 12 per cent of the investment portfolio. This was seen as a valuable way of driving improvements in the performance of companies, and especially in their corporate governance.

Fourth, while infrastructure investment to support private-sector development remained acceptable, Board members felt it could be more selective—public infrastructure projects accounted for 44 per cent of the portfolio—and better designed to address problems facing the private sector. At
the same time, the need for a commercially oriented approach with identification of revenue streams was emphasised. The Board made clear that it was for other IFIs to do the majority of large sovereign infrastructure loans.

The Board also advised selectivity on privatisation and restructuring operations and clarified that the primary focus of technical assistance should be project-related. A final recommendation was that the EBRD should move towards developing the private sector based on indigenous companies and away from joint ventures with foreign sponsors. At that point, foreign joint ventures had accounted for 46 out of 52 corporate investments. The corollary was a need to move operational staff closer to clients in the countries and employ more local staff.

Officials, clients and the business community in countries of operations agreed with the need for more local input and increased activity in the financial sector, including in venture funds.

The Task Force’s conclusions essentially defined the path for the EBRD over the coming years. By February 1994, they had been turned into a paper which fed into the Governors’ discussions at the Bank’s Annual Meeting. After the summer break, the material was used to define the strategic priorities for the Bank going forward and how they would be implemented. An internal paper on ‘Institutional Priorities and Medium-Term Scenarios’ framed the Bank’s operational intentions against the transition backdrop and provided for the first time a comprehensive plan for the future which was fully costed and budgeted for, including details on planning assumptions and upside and downside scenarios. By looking several years ahead, it became possible to understand better where management’s priorities stood and what resources and reallocations, might be necessary to achieve them.

De Larosière’s approach was beginning to bear fruit. With a comprehensive reorganisation of the core banking department delivered, costs under control, and a proper planning and budgeting system in place the EBRD was taking shape as a more mature institution.

4. Setting a Path Forward

De Larosière was conscious of the vital task of supporting the still nascent private sector in most countries of operations. Creating a competitive and efficient private sector could only be achieved through increased support for
smaller businesses and entrepreneurs, along with improved infrastructure to promote private-sector development. The Bank needed to scale up its activities in these areas and, as laid out by the Board, increase its local presence. To do that a number of further changes were needed.

The Task Force and the strategic papers that followed had pulled the threads of the organisation together and the internal restructuring had oriented the Bank for the future. A business model was beginning to emerge which could be strengthened by scaling up the impact of the Bank’s activities through greater use of intermediaries and greater local input.

Chief among the vehicles to be used were financial intermediaries and depository banks, in particular. By providing credit lines to these institutions and requiring that the funds be on-lent to SMEs, the multiplier factor associated with Bank funds could be vastly increased. This would make longer-term funds available to a wider range of private businesses and at the same time support the performance of commercial banks. There were some downsides from potentially smaller margins and less direct control but these could be offset though strict covenants limiting the size and type of loans on-lent, and the categories of firms eligible to borrow. As banks began to realise that this new business could be highly profitable, the hope was that lending to SMEs would continue to grow without the EBRD’s help.

Strengthening activity in the financial sector through credit lines had the additional advantage of helping the EBRD achieve its 60:40 ratio of private-to-public financing. Before de Larosière’s appointment, the Board had expressed its frustration at the management’s slow progress in bringing the portfolio ratio into line with the Article 11 requirement. Fortunately, the AEB had been crafted to ensure it was the ultimate beneficiary that provided the test for a private-sector classification rather than the intermediary through which the Bank’s funds passed. This meant that SME credit lines to state-owned banks counted as private-sector transactions in relation to the 60:40 ratio. (Transactions with state-owned companies being privatised or on a path to privatisation were also classified as private-sector deals.)

Other intermediaries targeted by the EBRD included equity funds. Equity was in very short supply in the region and provided greater leverage over companies than debt financing. The AEB ruled out majority control—another reason why equity funds provided a valuable alternative—but the abil-

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10 Article 11, paragraph iii.
ity to appoint nominee directors to boards and committees gave the Bank the opportunity to steer business plans, improve practices and introduce good corporate governance.

A further idea to reap economies of scale was the use of multi-product facilities for western industrial companies looking to invest in several countries in the region. Improvement in the mobilisation of additional funds for projects through syndication activities and other funding mechanisms, such as parallel and club loans, was also seen as a means to extend the Bank’s influence.

Scaling up, however, meant higher costs, which in turn could delay a shift to sustainable profitability. Plans to boost business activity were therefore matched by an increased focus on productivity and cost-control. Productivity of bankers as measured by average signed commitments per staff month had been falling. Credit lines and other ideas being floated had the advantage that they could be relatively large in volume, given that the funding needs of banks were generally greater than those of individual companies. They also offered economies of scale in processing. It was estimated that financial intermediary operations took 30 per cent less staff time to reach signing than average operations. Facilities, or frameworks, offered efficiencies in processing terms.

The second strand of thinking, a greater degree of localisation, had been brewing for a while. The number of countries of operations had expanded dramatically since the EBRD’s launch in 1991. The Bank was now active in 25 markets, which were very diverse in their degree of development and needs. More advanced countries were relatively accessible and could be managed through limited interactions with bankers, but countries at an early stage of transition needed much closer attention.

5. Increased Local Presence: Strengthening Regional Offices

The EBRD had been developing a network of regional offices from the outset. Both management and the Board saw the advantages of having a local presence, while countries welcomed the visibility of the Bank in their capitals and the recognition of their importance to the international community.

The main benefit, however, was as a focal point for communication. Bank officials could explain what the EBRD was designed to do and what it could offer, while local companies and entrepreneurs knew where to go for
much-needed finance. The Resident Office also provided a reporting link with headquarters, so that the latest developments in the country were always close to decision-makers back in London. In many cases this was essential given language and media barriers, including state-controlled reporting restrictions.

The first Resident Office was opened in Warsaw in January 1992. By the end of the year, a further six had been opened—in Budapest, Sofia, Prague, Moscow, Tirana and Kyiv—and by the start of 1994 the total had risen to 12. Not all had finalised the legal Host Country Agreements necessary to ensure the Bank’s rights and immunities would be respected, but the rapid pace of deployment indicated the emphasis placed on a local presence.

In this period, a typical Resident Office was very small, comprising two professionals and two support staff. There was a total of 19 expatriate staff in Resident Offices by the end of 1993. Few were professional bankers and their remit was limited. Essentially, their function was to promote the Bank’s services, undertake some reporting duties, and host senior management visits and missions. They also provided useful input in the preparation of country strategies. There was a growing feeling, however, particularly in the Merchant Banking Division, that they could do more to help.

The 1993 Task Force concurred with the view that Resident Offices were an underutilised resource and poorly integrated into the main business activities of the Bank. It concluded that much more localisation was appropriate for the EBRD to be successful in its transformative mission. Private-sector development required the input of experienced practitioners on the ground and accelerating the Bank’s investment activity would be enhanced by able bankers who knew how to find and screen project opportunities.

The Board paper on guidelines for the medium term, which built on the Task Force conclusions, made clear that “stronger local presence was ... one of the key priorities of the Bank”. Following the reorganisation towards a more country-focused structure, Resident Offices became an integral part of the Country Teams that now had operational responsibilities within a single Banking Department. A paper on “Stronger Local Presence”, circulated in October 1994 following discussions with the Board and Resident Offices, noted the management’s view that the EBRD would gain effectiveness and local profile through strengthening its local presence: “The new approach is operationally driven, breaking with the past where offices were mainly representational.”
The approach was consistent with the Bank’s other efforts to build a local presence, particularly through financial intermediaries. Local investors were being reached through investment funds, direct loans to banks and for on-lending to local companies, and co-financing. Establishing and managing client relationships effectively, however, whether private or public, required a professional presence on the ground. Not only would it encourage better marketing of the Bank’s services and a stronger flow of projects, but also demonstrate the EBRD’s complementarity with other international banks and IFIs, and reinforce its separate identity.

There were other good reasons for strengthening the role of Resident Offices. London was too remote to be of much help with smaller projects. As markets developed, and with them financial intermediation, the operational emphasis turned towards assisting companies unable to access finance. Many were SMEs and local entrepreneurs, dealing with whom involved a higher degree of risk and required a greater depth of local knowledge.

Local presence was important too for managing complex privatisation and restructuring cases, which involved extensive preparation and regular follow-up. An increasing number of technical cooperation projects required more time in situ by relevant experts. As the Bank’s portfolio grew, implementation and monitoring of the stock of projects was also an increasing challenge. Field supervision, explanation and chasing of covenants, watching financial developments, sitting on company boards and diligence work were time-consuming and better performed on location. It was also believed that increased investment in the Resident Office network would strengthen the corporate culture of the EBRD as a “transition bank”.

The next few years saw a significant increase in local capacity. By mid-1999, the Bank had Resident Offices in 30 locations with a total of 255 staff. Secondments from headquarters comprised about one-quarter of the professional headcount, with the remainder recruited locally. In addition, as part of its efforts to strengthen financial intermediaries in less developed countries and regions, a number of secondments were made directly to local commercial banks and other institutions.

A review in 1999, as part of a medium-term strategic assessment under Horst Köhler’s Presidency, concluded that the effort to develop a local presence was working well but could be reinforced in some areas. Suggestions included: providing leadership for the development of business start-ups and SMEs; exploring restructuring of large enterprises where close day-to-day in-
volvement with clients was essential (as had been shown in several complex privatisation and restructuring projects in Poland and Hungary); taking an active approach to equity investment, where again regular interaction with the management and owners of companies was essential for success; and promoting better institutions and a stronger investment climate. The report clarified further Resident Office staff’s membership of project teams and their role in originating and screening project opportunities, particularly where they were best-placed to understand the nature of the risks faced. The significantly increased presence of operational bankers on the ground and the linking of the Resident Offices more fully into the Banking Department’s operational planning processes strengthened considerably the EBRD’s relationships with clients, country authorities and business associations, and gave it much greater visibility where it was most needed. Frequent visits by heads of Resident Offices to London to support and defend projects based in their countries helped them understand the wider political context of the Bank’s work, and provided Board Directors with a clearer appreciation of the operating context for the Bank’s investments and its engagements with authorities.

6. **Preparations for a Capital Increase**

By 1994, the EBRD was finding its feet in terms of its business operations. Annual commitments in the previous year had reached ECU 1.5 billion, with the private sector beginning to feature strongly. The portfolio ratio, which had been the subject of close attention during the previous two years, was still only at 50:50 but the direction of travel was clear. Reaching the 60:40 private-public goal was now simply a matter of time, at least in aggregate. There remained work to do to achieve this ratio in many markets, notably in early-stage transition countries, but the Board had recognised this challenge and allowed some leeway.11

From de Larosière’s perspective, the banking side of business was not the key problem, particularly now that it was under one roof and fully in the capable hands of Freeman. Two different concerns presented themselves. The first was that the EBRD had yet to prove it could become a profitable or-

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11 A five-year period was set, with provision for a timetable and targets for achieving the ratio to be set at the end of the period if necessary. See ‘Portfolio Ratio: Individual Countries of Operations’, EBRD, 1995.
ganisation. Two years passed before the Bank started making profit; meanwhile some small losses resulted from the early investments. The Bank started making money in 1993, but only just. At ECU 4.1 million, profits after provisions did not even cover the previous year’s losses. With assets of over ECU 7 billion and members’ equity of ECU 3 billion, the Bank knew it should start earning more. It was still, of course, early days for the new institution. Productivity, in terms of commitments and income generated relative to administrative expenses, had to improve markedly over the coming years if sustainable profitability was to be achieved.

De Larosière’s introduction of a tough budgetary regime was part of a focus on longer-term financial sustainability. General administrative expenses had increased almost threefold between 1991 and 1993. Net income was growing strongly but an increase in the stock of commitments in higher-risk countries meant provisions for loan losses were growing faster still.

The effect of his approach had been immediate, stopping the growth of administration expenses in its tracks. So strict was budgetary control during de Larosière’s time as President that general administration expenses were the same in 1997 as they had been in 1993. As he commented in his farewell remarks to the Board in 1998:

Keeping a tight rein on the budget is not a mania that I have developed. It is indispensable. Look at the figures. Suppose we had, like many institutions do, increased our budget in nominal terms by 5 per cent a year which, after all, with an inflation of 2 to 3 per cent and with a portfolio that has increased by significantly more than 20 per cent a year, might have been envisaged by some. With such a scenario, we would have ended up with five consecutive years in the red with losses of over ECU 20 million a year: the Bank would be in shambles, our capital would not have been doubled and I would not be talking to you today... Experience shows us that the best performers in the financial sector are the ones who keep to the cost cutting line.14

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12 Losses in 1991 and 1992 were ECU 7.1 million and ECU 6.1 million, respectively.
13 General administration expenses were recorded as ECU 137.3 million in 1993 and ECU 137.1 million in 1997. Meanwhile operating income grew from ECU 191.3 million to ECU 346 million. A rapid expansion in provisions for losses however from ECU 39.4 million to ECU 177.7 million meant that profits only increased by a small amount to ECU 16.1 million by 1997.
Losses and weak profitability also restricted the growth of reserves. In turn, this constrained the scope for growth of the Bank given the statutory requirement in Article 12.1, which limited total commitments to the sum of unimpaired capital, reserves and surpluses. De Larosière could see a further constraint looming in the coming years: the need to pursue more equity and growth in less advanced countries. This was the right strategy for the organisation but it would mean taking greater risks and invoke higher provisions. A greater financial cushion was going to be needed to ensure the steady growth of business and its diversification.\textsuperscript{15}

This fed into the question of whether to push for a capital increase. Article 5.3 of the AEB required a review of the Bank’s capital stock “at intervals of not more than five years”. Following the EBRD’s inauguration in 1991, a decision would have to be taken by the 1996 Annual Meeting.

De Larosière was clear that a capital increase would be required sooner rather than later if his plan to expand business was to be realised. With commitments increasing at a rate of ECU 1.5 billion to ECU 2 billion a year, headroom—the difference between statutory capital and outstanding commitments—would shrink fast. The “trigger” for headroom, which was set at 90 per cent of the statutory limit to allow for volatility in exchange rates, would be breached before the decade was out at this rate of business growth. De Larosière had no desire to alter the gearing ratio. “The financial integrity of the Bank does not allow tinkering with this,” he commented.

From his experience with Quota Reviews at the IMF, de Larosière was aware that discussions with shareholders on matters of capital frequently took a long time to resolve. He therefore determined that demand assessments, technical scenarios and other material should be developed in time for Governors to approve a proposal at their 1995 Annual Meeting for a formal study on capital resources. A draft proposal on a capital increase would then be presented by the Board of Directors to Governors as a Resolution to be voted on at the 1996 EBRD Annual Meeting in Sofia.

Success depended on convincing the Board, and Governors, that the EBRD was likely to continue to grow fast, was having an impact on the transition process, and that failure to grant a capital increase would jeopardise its

\textsuperscript{15} This was especially true as the income from the EBRD’s Treasury operations provided critical support to the Bank’s financial performance.
role. It was here that Chief Economist Nick Stern and his team, and others drawn from the Project Evaluation Department and Banking, made a substantial contribution. They provided a frame of reference through which progress in transition could be understood, and with it the challenges ahead and how the EBRD could address them through its operational activities, business and operational model, financial instruments and business tools, delivery capacity and financial situation.

To help, in 1994 Stern introduced the first *Transition Report*, which became EBRD’s flagship annual economic publication. Notably, the report introduced a series of transition indicators that measured progress in structural reform across countries in areas such as privatisation, enterprise restructuring or trade liberalisation. These indicators were backdated to 1989. Together with the effort on operational priorities, which included “guidelines for the medium term”, started soon after de Larosière’s arrival, this work set the tone for the strategic review ahead.

Combined with analyses of institutional priorities, medium-term scenarios and financial considerations undertaken over the following year, the material fed into the final Capital Resources Review in November 1995, which set out all the relevant information covering the period ahead (1996–1999) for Governors at their meeting in Sofia. The approach was repeated subsequently at each five-year interval dictated by Article 5.3, with a five-year (rather than four-year) planning timeframe and the addition of more detailed reviews of the Bank’s contribution to transition impact.

One aspect of the analysis that would become a prominent feature of the debate between the Board and the management was the assessment of the way the transition process was evolving and its implications for Bank resources. More advanced countries such as Hungary and the Czech Republic were moving rapidly towards functioning market economies, while several CIS countries still had a long way to go. Where reform-mindedness was weak, demand for EBRD activities was poor and the risks associated with operations were high. Conversely, the Bank could contribute successfully where serious reforms were being undertaken. However, in the latter case, the EBRD’s additionality and the set of transition targets were likely to narrow over time, reducing demand for the Bank’s services. This suggested an S-shaped path towards demand for EBRD investment as countries pro-

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16 The measurement of transition is discussed in more detail in Chapter 10.
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gressed along the transition path. It implied weaker demand at early and advanced stages of transition than at the intermediate stage. In 1995, the Bank argued that the majority of countries were in the intermediate zone. Demand remained strong even in more advanced countries where, for example, an influx of foreign direct investors and increasingly domestic investors were keen on obtaining EBRD support. Given the scale of the region’s investment needs, it was not difficult to construct scenarios even on moderate business volume growth—after allowing for efforts to sell-down loans and equity, and recirculate capital—which showed a need for more capital by the end of the projection period (1999).

On the basis of the main projection, described as a “manageable growth” scenario, management argued for a 100 per cent increase in the capital stock. With annual business volume assumed to increase steadily from ECU 2 billion in 199617 to ECU 2.5 billion in 1999 (and 5 per cent per annum in nominal terms thereafter), the projections showed headroom would disappear in 1998, forcing an immediate drop in business volume to around 10 per cent of its annual level to be consistent with long-term financial sustainability. A 50 per cent capital increase would extend the time before a similar effect occurred to 2000, while a doubling of the capital stock suggested there would be no need for “additional capital in the foreseeable future”.18

Management also argued for the paid-in portion to be 30 per cent, as had been applied to the EBRD’s original stock. The chief argument used was the intention to increase the proportion of equity in the Bank’s portfolio, but a build-up of reserves was also suggested as a reason. Article 12.3 limited equity commitments to the sum of paid-in capital, reserves and surpluses so this acted as a constraint but was not as severe as the overall one, even in higher equity growth scenarios.

At the Annual Meeting in April 1996, the Governors accepted the Bank’s analysis and unanimously agreed to a doubling of the Bank’s capital from ECU 10 billion to ECU 20 billion. However, for budgetary and other reasons they restricted the paid-in amount to 22.5 per cent rather than the 30 per cent sought by the management. Three countries—Mexico, New Zealand and Morocco—decided not subscribe to the increase.

17 Estimates for 1995 showed ECU 1.9 billion, up from ECU 1.74 billion in 1994 and ECU 1.5 billion in 1993.
18 The projection indicated that the 90 per cent ‘trigger’ threshold would be reached around 2004 though a more proactive portfolio turnover could extend this further (just as faster volume growth would bring it forward).
7. The Matter of ‘Graduation’

EBRD Governors had agreed to secure the Bank’s future and role in fostering the transition of its countries of operations on the basis of management’s arguments and the political context of wanting to show continuing support for the region’s reorientation towards market democracy. The new capital would help some of the more advanced countries accede to the European Union, which now loomed on the horizon, and there was work to do to encourage less advanced reformist countries in their transition.

It was clear that in granting a doubling of the EBRD’s capital stock Governors saw it as a one-off decision. There could be no repeat for the foreseeable future. Nor would it be appropriate for the Bank to consider any relaxation of cost controls. Indeed, a view developed among Board Directors in the aftermath of the discussion that a root and branch review of productivity and operating practices would be appropriate to ensure the best use of capital going forward. In response, management introduced a zero-base budgeting (ZBB) exercise soon afterwards.19

One issue however, which had become a focal point for debate in the discussions leading up to the capital increase, was ‘graduation’, shorthand for when a country would no longer be in need of EBRD finance and resources. The AEB had not provided a definition of what was meant by a market economy or criteria by which to judge when the transition was complete. With fast improvements being seen in the market development of some central European countries several Board members felt that the time was right to clarify the issue. In their Report to Governors on the Capital Resources Review, the Directors thus recommended a commitment be made to prepare a policy on graduation before the end of the year, which was agreed by Governors at the Sofia meeting.

Preparatory work20 had made clear that graduation could be considered only with reference to the Bank’s own operating principles—additionality, transition impact and sound banking21—rather than to per capita income levels or other measures of advancement used in most development

19 Ideas were discussed in 1996 during the debate on the 1997 budget and a ZBB Initiative was launched in January 1997.
21 Reference to environmental factors was added later in view of Article 2 and the legacy of environmental problems in the region.
banks. What mattered was whether there remained profitable operations which advanced transition and where similar finance on reasonable terms and conditions could not be obtained from elsewhere. The key test was the Bank’s additionality. In the limit, the Bank’s finance would be unnecessary, or even counterproductive, and the country would manage its own affairs through the presence of effective financial institutions and an efficient capital market.

As a project-oriented institution, a ‘bottom-up’ test could be applied to every project. But this was not sufficient for a complete understanding of graduation. The market level, or a ‘top-down’ perspective, was relevant, too. Where markets and institutions had reached an advanced stage, that is where they were open and competitive and functioning well, the EBRD was unlikely to fulfil the additionality criterion. The combination of ‘bottom-up’ and ‘top-down’ approaches meant there was scope for sectoral analysis and judgements over which activities and instruments might no longer be relevant to the achievement of the Bank’s goals.

As transition advanced, therefore, it was expected that the EBRD would move away from certain areas of activity. Analysis of the product mix showed this was already happening to some degree. The Bank had for example moved away from sovereign infrastructure projects and other state loans towards private loans and equity in advanced countries. The pattern of FDI and the Bank’s involvement with it was also changing with domestic investors in the most advanced countries scaling up and foreign investors more comfortable with local market conditions.

The transition indicators too, which had been developed in part to assist with the graduation debate, brought the ‘top-down’ perspective into sharper relief by showing that Hungary, the Czech Republic and Poland were well ahead of other countries of operations with the Slovak Republic, Slovenia and Estonia not far behind.

22 Graduation from IDA, the fully concessional arm of the World Bank Group, is based on GDP per capita for example.

23 In the early years the EBRD had been a significant catalyst for foreign investment in the region, providing finance for projects that represented “more than 5 per cent of total investment taking place in the Bank’s countries of operations” (Capital Resources Review 1995) with the share of FDI in countries of operations “surpassing 15 per cent each year before 1995.” (Capital Resources Review 2001) As the second half of the 1990s began, these percentages began to diminish.

24 See Table 10.1 in Chapter 10 which shows the relative positions of countries of operations as measured by the transition indicators at the time, 1995.
Management presented their conclusions in a final policy paper on graduation in November 1996:

The Bank will have achieved its objective when it is no longer additional. That will be a measure of the success of the transition and of the Bank. In countries which are very advanced in transition [graduation] will de facto start to occur ... when the areas of Bank additionality have decreased to such an extent that demand for EBRD services has withered away. At that point a country of operations may indicate a wish to graduate.\textsuperscript{25}

Nonetheless, the paper noted “even the most advanced countries of the region are some distance away from meeting the standards of a well-functioning market economy.”

Among the areas that were expected to continue to develop were the environment, commercial infrastructure, banking and financial development (including for SMEs), enterprise restructuring and investments to help countries respond to intensified competition and trade reorientation. There was no suggestion that any country of operations was close to the point of graduation.

The Board agreed that graduation could not be mechanistic or deterministic and cautioned against seeing transition as a linear process. Instead, the Bank could shift its product mix according to demand, dropping back from areas where it was no longer additional but responding to new demands and opportunities, especially in more risky areas, even in the most advanced countries. Eventually, countries of operations would rely on their own resources and capital markets to provide finance and risk-taking capacity. But in their view that point, the end of the transition, was not yet in sight since there was still significant demand for the Bank’s financing in areas in which it could be additional and a strong wish on the part of the countries concerned that the EBRD remain active in their markets. Graduation was not seen as an imminent prospect.

Shareholders also took the view that geographic shifts in EBRD operations should take place only gradually to maintain portfolio balance, credit quality and profitability.

As far as the legal position was concerned, the General Counsel, John Taylor, reassured the Board that the policy fell squarely within the scope of the AEB and Article 29.3\textsuperscript{26}, since the policy would result in graduation of a country only through the natural consequence of the application of the Bank’s basic operating principles and, importantly, only with the concurrence of the country itself.\textsuperscript{27} Alternative routes through numerical scores, indicators or force majeure were regarded as legally complex and requiring a Board of Governors’ decision.

The agreed policy decision was that the application of the Bank’s principles throughout the project cycle would determine graduation at the project and sub-sector level. At the country level, the transition indicators provided guidance but would need to be supplemented at the time in country strategy reports with up-to-date information on the availability of domestic and external finance for sovereign and corporate borrowers, credit agency ratings and terms and conditions of borrowing.

Conclusion

In line with the Governors’ request at Sofia, the issue of graduation had been resolved by the end of the year with a policy clarified and agreed. The conclusion that no country of operations was yet ready to embark on a graduation path was helpful in attenuating the debate and preventing distractions when there was clearly still much to do. There was advantage in reaching an early policy conclusion in an era when the issue was less contentious than it would be a decade or so later.\textsuperscript{28}

The Governors’ decision to go ahead with a capital increase meant de Larosière, and his successors, could embark on a programme of rapid expansion to deliver the transition results shareholders hoped for. It was a vote of confidence in the EBRD and de Larosière, in particular. His strategy of re-organising the Bank and focusing on what was needed for steady growth had paid off. As he later wrote:

\textsuperscript{26} With a two-thirds of voting power majority.
\textsuperscript{27} ‘Memorandum on Legal Aspects of the Proposed Policy on Graduation of EBRD Operations’, 13 November 1996.
\textsuperscript{28} See Chapter 12.
[The decision to double the capital was] a significant acknowledgement of the fact that the now profitable institution was operating in the interests of both the countries of operation and the shareholders ... The decision ... really marked the end of the crisis: the EBRD was no longer a subject of debate, mockery and controversy. It had gotten its credibility back. After that, no one dared to challenge its usefulness and merits.²⁹

²⁹ de Larosière, 50 Years of Financial Crises, p. 179.