Chapter 10

Embedding Impact in the Business Model

Introduction

By the mid-1990s, the stars had begun to move in the EBRD’s favour. The triumvirate at the top were in many ways the ideal combination to stabilise the Bank and set it on a path for success. De Larosière, the internationally respected grand-homme of international finance, a man of great foresight and an astute manager; Ron Freeman, an investment banker with a strong pedigree who understood continental European concerns as well as Anglo-Saxon foibles; and Nick Stern, a well-connected and respected professor of economics with strategic vision who was able to combine theory with practice and get ideas across effectively to a wide range of audiences. Improvements in the economic circumstances of most countries in the region from now on also meant that the timing for a concerted effort to expand and influence the path of transition was auspicious.

As the Bank moved forward, a new methodology to define and measure transition impact was devised over several years, which helped everyone in the institution understand and explain to clients how the EBRD differed from commercial banks. The methodology allowed the Bank to present its activities—from projects and country and sector strategies to strategic and business plans—to shareholders and others in an intellectually consistent and coherent way, and provided a unity of purpose to staff and external observers alike.
1. Defining and Operationalising the Bank’s Purpose: Transition Impact

The banking side of the EBRD, reorganised under a tough but respected taskmaster with free rein to drive the business forward at pace, was clear on its remit. The wider organisation needed a similar clarity of purpose. It was here that Stern had a great impact.

Now almost three years old, the EBRD did not yet have a coherent organising philosophy within which to develop and focus its activities. The transition mandate had always been the guiding principle but was not embedded within the Bank in a systematic way. Board project documents did refer to transition impact—mentioning, for example, potential benefits of an operation to market development—but there was no means of assessing it. To the extent that economic tests of validity were used in project analysis, they focused sometimes on the costs of protection but mostly on more general economic rates of return (in line with other development organisations), although often only in a cursory way. The Project Evaluation Department (PED) took a similar economic return approach to ex post evaluations.

While such exercises were useful up to a point, they failed to address the dynamic nature of the context—notably that the EBRD was trying to put markets in place rather than adding incrementally to them—and were expensive to carry out when done properly. Methodological improvements were needed to deal with the particular situation of the transition economies and the Bank’s operations.

This was a task Stern was eminently well-placed to carry out. In doing so, he was supported early on by a number of EBRD colleagues: Hans Peter Lankes, a recent Harvard PhD graduate, who took on the task of defining how projects should be assessed, and Robin Burgess and Mark Schankerman who were hired to provide more theoretical underpinnings to Stern’s thinking. Like Stern, Schankerman was a professor of economics at the LSE and was seconded to the EBRD as Director of Policy Studies. Burgess was a recent Oxford doctoral graduate interested in development econom-

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1 For some big corporate investments at the time such as in Hungary and the CSFR, especially in the automobile sector, this was an important aspect to consider. The EBRD always paid close attention to protection issues, in line with its focus on supporting effective market competition.

ics who joined the Bank as a consultant. In a paper on ‘Investment Projects and the Transition Process’ they set out a new and radically different approach to project appraisal which emphasised the broader, dynamic impact of investments rather than relying on the comparative static analysis adopted by others.3

Stern was an expert in public-sector economics and had already written prominently on many aspects of cost-benefit analysis.4 However, in the context of the rapidly changing economic systems and structures of countries moving from central planning to market economies, he realised that the limitations of cost-benefit analysis were severe and reduced its value as a decision-making tool. For example, two similar new road projects might have the same effects in reducing journey times and improving safety (which could be costed on suitable assumptions), but if one, say, was designed as a public-private partnership, it might result in capacity building and demonstration effects going beyond quicker and safer access to yield valuable efficiencies in future infrastructure investments. Similarly, if it opened up linkages between an isolated region and a port with international access, over time it could draw in previously cut-off businesses, expand markets and improve growth to generate higher returns than envisaged in a simple model. Cost-benefit analyses tended to shy away from such issues because of the uncertainties involved and the difficulties in producing reliable quantitative estimates of their value. Ignoring these dynamic effects in the transition context would, however, be potentially misleading as to the absolute and relative benefits of different projects.

In the Lankes, Burgess, Schankerman and Stern view of the world it was the systemic impact of projects that mattered, not simply their immediate financial or even economic returns (as conventionally measured). This was especially important for an international institution such as the EBRD which sought to play a role in influencing outcomes beyond the companies and financial institutions in which it invested. The provision of finance alongside other investors was important, but choosing to support projects that had impact beyond the investment itself was even more so. Hence, the idea was to concentrate on the effects of projects “which may induce important reac-

tions outside the boundaries of the project but which may not easily be captured by the comparison of equilibriums ‘with and without the project’.”\(^5\)

It was also relevant from another angle. The amount of capital available for the EBRD to deploy fell far short of the needs of the region. Careful project selection was essential to maximise the Bank’s impact.

The underlying basis for this viewpoint had its origins in central Europe. The Austrian School, dominated by the ideas of Ludwig von Mises and his pupil Frederich von Hayek and later, from a different perspective, those of Joseph Schumpeter, was a key influence. The important aspects that underpinned their thinking were born of the uncertainties associated with the social, economic and political upheavals of the first half of the 20th century: the shocks imparted by two World Wars and the Great Depression. There were parallels in the collapse of central planning and efforts to replace it with market capitalism.

Von Mises and von Hayek emphasised the dynamic aspects of change, with “markets as a process”, and the learning and discovery that takes place through competitive mechanisms and in particular through competitive prices. Competitive market interactions between the myriad independent actors dispersed information and knowledge which could be mobilised to drive economies. In Schumpeter’s view, this provided the vehicle for the discovery and innovation of new products and processes which would overtake the status quo (“creative destruction”). The market was seen as a dynamic and creative phenomenon.

This suggested an alternative approach to the appraisal of projects in the transition context, one based on the nature and dynamic aspects of markets. It could take account of backward and forward linkages (effectively supply chains), which influenced the scale and pace of development and the behaviours of markets, driving participants to keep up with competitors and develop skills and innovations to surpass them. A key addition by the EBRD’s economists, compared with their Austrian antecedents, was the inclusion of institutions and policies that could influence markets. In the fluid world of transition, the rule of law, level of openness and transparency, and strength and fairness of regulation were important influences on market outcomes and could not be ignored.

The team began to build, over a series of iterations, an analytical system which suited the Bank’s needs. Starting with a set of indicators of transition progress presented to the Board in 1994 and progressing to a project-level approach after considerable discussion with the banking and evaluation departments, the main elements of the new “transition impact” methodology emerged gradually over several years. The effort to move from the intuitive notion of transition impact of earlier times towards a more structured approach was welcomed by Directors.

The starting point was a thorough assessment of the state of transition in the EBRD’s countries of operations in a new publication, the Transition Report, issued by the Bank in November 1994. This was the first of what became an annual and much admired series, each of which was the sole responsibility of the Chief Economist. The Transition Report 1994, produced by the Office of the Chief Economist (OCE) under the editorial direction of Kasper Bartholdy, was almost 200 pages long and mirrored the World Bank’s flagship World Development Report. It covered many aspects of transition, from the macroeconomic situation of the region and its individual countries to the pace of institutional change, FDI and trade-policy reform. It was a remarkable achievement for such a small office.

A key consideration, set out at the start of the publication, was the meaning of transition and its measurement. Written by Stern and his predecessor, Flemming, it explained:

Transition is not only an intermediate goal contributing to economic development ... The market economy, in contrast to central planning, gives, in principle, the individual the right to basic choices over aspects of his or her life ... The right to these choices may be seen as a basic liberty ... Thus the transition is also an end in itself ... The transition concerns institutional change. It is the institutional arrangements for the allocation and generation of goods and resources, and the ownership incentive and reward structures that institutions embody, that characterise the differences between a market and a command economy.

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6 Although all interested parties are consulted, Transition Reports do not necessarily represent the views of the EBRD’s senior management or those of its shareholders.
7 Flemming helped lead the editorial team in which Andrew Tyrie also played a substantial role.
9 Ibid., p. 4.
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Citing the contrasts between Japan, Germany and the USA, however, Stern and Flemming cautioned:

... it must be remembered that there are many varieties of market economy which may be viewed as the ‘end point’ or ‘target’ of the transition ... [there] is not a simple, linear, one-dimensional progression to a ‘standard’ market economy.\(^{10}\)

The key elements of a market economy in their characterisation were: enterprises and households making decisions over production and consumption in response to incentive structures embodied in markets; markets themselves, which were the means by which goods and resources were exchanged; and financial institutions, which allowed the channelling of savings, investments and payments and supported financial discipline.

The state was seen as playing an important role, albeit a very different one from under a command economy, namely as the source of legal and regulatory structures concerning the behaviour of enterprises and financial institutions, property rights, contracts and market functioning, as well as the provider of public goods, taxation, safety nets and protection against poverty.\(^{11}\)

2. A Set of Transition Indicators

This thinking led to a first set of transition indicators designed to measure the state of transition in the EBRD’s countries of operations. Over the course of 1995, they were refined and published in that year’s Transition Report. Four categories were used to represent the components of the market economy described above: enterprises, markets and trade, financial institutions and legal reform. Each category was sub-divided into discrete dimensions of transition, from large-scale privatisation to price liberalisation, banking reform and effectiveness of legal rules on investment. A classification system was then applied to each indicator to express the extent to which progress had been made against a hypothetical yardstick of the standards expected to be seen in an advanced industrial economy. Scores ranged from 1,
indicating little or no progress, to \( 4^* \), representing the level of an advanced industrial nation. Table 10.1 below shows the structure of the indicators as they appeared in the Transition Report 1995.

**Table 10.1 Transition Indicators, 1995**

<table>
<thead>
<tr>
<th>Country</th>
<th>Enterprises</th>
<th>Markets and Trade</th>
<th>Financial Institutions</th>
<th>Legal Reform</th>
<th>Average Score</th>
<th>Level of Advancement</th>
</tr>
</thead>
<tbody>
<tr>
<td>Albania</td>
<td>2.7</td>
<td>2.7</td>
<td>1.5</td>
<td>2.0</td>
<td>2.2</td>
<td>B</td>
</tr>
<tr>
<td>Armenia</td>
<td>2.3</td>
<td>2.3</td>
<td>1.5</td>
<td>2.0</td>
<td>2.0</td>
<td>B</td>
</tr>
<tr>
<td>Azerbaijan</td>
<td>1.3</td>
<td>2.0</td>
<td>1.5</td>
<td>1.0</td>
<td>1.5</td>
<td>C</td>
</tr>
<tr>
<td>Belarus</td>
<td>2.0</td>
<td>2.3</td>
<td>2.0</td>
<td>2.0</td>
<td>2.1</td>
<td>B</td>
</tr>
<tr>
<td>Bulgaria</td>
<td>2.3</td>
<td>3.0</td>
<td>2.0</td>
<td>3.0</td>
<td>2.6</td>
<td>B</td>
</tr>
<tr>
<td>Croatia</td>
<td>3.2</td>
<td>2.7</td>
<td>2.5</td>
<td>3.0</td>
<td>2.9</td>
<td>B</td>
</tr>
<tr>
<td>Czech Rep.</td>
<td>3.8</td>
<td>3.5</td>
<td>4.0</td>
<td>3.6</td>
<td></td>
<td>A</td>
</tr>
<tr>
<td>Estonia</td>
<td>3.7</td>
<td>3.3</td>
<td>2.5</td>
<td>3.0</td>
<td>3.1</td>
<td>A</td>
</tr>
<tr>
<td>FYR Macedonia</td>
<td>2.7</td>
<td>2.7</td>
<td>2.0</td>
<td>2.0</td>
<td>2.4</td>
<td>B</td>
</tr>
<tr>
<td>Georgia</td>
<td>2.3</td>
<td>2.0</td>
<td>1.5</td>
<td>2.0</td>
<td>2.0</td>
<td>B</td>
</tr>
<tr>
<td>Hungary</td>
<td>3.8</td>
<td>3.5</td>
<td>3.0</td>
<td>4.0</td>
<td>3.6</td>
<td>A</td>
</tr>
<tr>
<td>Kazakhstan</td>
<td>1.7</td>
<td>2.7</td>
<td>2.0</td>
<td>2.0</td>
<td>2.1</td>
<td>B</td>
</tr>
<tr>
<td>Kyrgyzstan</td>
<td>3.3</td>
<td>3.0</td>
<td>2.0</td>
<td>2.0</td>
<td>2.6</td>
<td>B</td>
</tr>
<tr>
<td>Latvia</td>
<td>2.7</td>
<td>3.0</td>
<td>2.5</td>
<td>2.0</td>
<td>2.6</td>
<td>B</td>
</tr>
<tr>
<td>Lithuania</td>
<td>3.0</td>
<td>3.0</td>
<td>2.5</td>
<td>2.0</td>
<td>2.6</td>
<td>B</td>
</tr>
<tr>
<td>Moldova</td>
<td>2.7</td>
<td>3.0</td>
<td>2.0</td>
<td>2.0</td>
<td>2.4</td>
<td>B</td>
</tr>
<tr>
<td>Poland</td>
<td>3.5</td>
<td>3.5</td>
<td>3.0</td>
<td>4.0</td>
<td>3.5</td>
<td>A</td>
</tr>
<tr>
<td>Romania</td>
<td>2.3</td>
<td>2.8</td>
<td>2.5</td>
<td>2.0</td>
<td>2.4</td>
<td>B</td>
</tr>
<tr>
<td>Russian Fed.</td>
<td>3.0</td>
<td>2.7</td>
<td>2.0</td>
<td>2.0</td>
<td>2.4</td>
<td>B</td>
</tr>
<tr>
<td>Slovak Rep.</td>
<td>3.5</td>
<td>3.5</td>
<td>3.0</td>
<td>3.0</td>
<td>3.3</td>
<td>A</td>
</tr>
<tr>
<td>Slovenia</td>
<td>3.5</td>
<td>3.2</td>
<td>3.0</td>
<td>3.0</td>
<td>3.2</td>
<td>A</td>
</tr>
<tr>
<td>Tajikistan</td>
<td>1.7</td>
<td>2.0</td>
<td>1.0</td>
<td>1.0</td>
<td>1.4</td>
<td>C</td>
</tr>
<tr>
<td>Turkmenistan</td>
<td>1.0</td>
<td>1.3</td>
<td>1.0</td>
<td>1.0</td>
<td>1.1</td>
<td>C</td>
</tr>
<tr>
<td>Uzbekistan</td>
<td>2.7</td>
<td>2.3</td>
<td>2.0</td>
<td>2.0</td>
<td>2.3</td>
<td>B</td>
</tr>
</tbody>
</table>

For simplified presentation purposes sub-indicators have been aggregated and averaged; similarly for the overall average score. Level of Advancement categories: A, average score 3 and above; B, between 2 and 3; C, score less than 2. \( 4^* \) cases were treated as having a value of 4.5. There were 12 such scores out of a total of 225. For a more complete picture, see Transition Report 1995, Table 2.1, p. 11.
The application of the system to the EBRD’s countries of operations provided a helpful picture of the region’s progress and highlighted the considerable differences between countries. Some, like Turkmenistan, scored mostly ‘1’ across the set of indicators, while more advanced economies such as Hungary and the Czech Republic scored in a range between ‘3’ and ‘4+’. The system provided a set of development indicators from a transition perspective and a means of calibrating progress against increasingly objective evidence. Intellectually, it was very appealing and offered the prospect of a regular snapshot, as well as opportunities for academic researchers and others to assess and track progress across central and eastern Europe, Russia and beyond. But there was a desire internally to see if the approach could be applied more directly to the Bank’s operations and to the strategies that were developed for each of the EBRD’s countries of operations.

To spearhead the effort of applying transition impact criteria more widely to Bank activities, an interdepartmental working group consisting of the OCE, Banking and PED was formed early in 1995. This followed a successful Board retreat where the transition indicators had been discussed as a response to questions about the Bank’s overall impact on transition. The aim of the group was to take forward the qualitative aspects of the transition indicators presented in the Transition Report and turn them into a checklist that could assist operations staff in focusing on the key dimensions of transition impact in project selection, design and appraisal. If successful, the set of criteria developed could be used to examine the transition impact of EBRD projects at each stage of their development, from first appraisal to the portfolio and their evaluation post-completion.

In order to gauge the usefulness of the idea, Stern proposed to apply the draft project-level indicators of transition impact to the stock of signed projects, which then stood at around 200. To help with the exercise, Professor Paul Hare of Heriot-Watt University, Edinburgh, was employed as a consultant. One of the reasons for inviting his participation was that the project had an underlying research purpose, namely to determine the extent to which the “contribution to transition” criteria differed from conventional financial and economic return indicators. Bankers from eight teams were also invited to score some of their own projects using 14 indicators, three of which related to enterprises, three to financial institutions and eight to markets and trade, with some overlaps. The scoring range for each indicator was from ‘-1’ (negative effect) to ‘3’ (very significant positive effect).
At a workshop at the EBRD in 1995, Hare and Tanya Normak (an economist in OCE) presented preliminary ideas on the transition impact criteria and their research proposal. It was followed by a presentation of their findings at an EBRD research conference in April 1996. Based on an econometric analysis of the Bank’s projects using the 14 transition indicators and other project features, the paper concluded:

that the set of transition indicators is both conceptually and statistically coherent, that there is little evidence to suggest that one or other indicator or subset of indicators can usefully be replaced by a single, composite or synthetic indicator, and that these indicators do not merely replicate information already contained in standard project-based financial indicators [FRR and ERR]. Hence the measures of ‘contribution to transition’ proposed ... could usefully be incorporated in the Bank’s project appraisal procedures.

This provided valuable support for the approach. A follow-up report on implementation issues considered the questions of aggregating indicators and the responsibility for the assessment of transition impact. The first question arose in part because the PED, which had adopted the indicators in its work, had gone further in its analysis by aggregating individual scores into a single numeric measure. Views differed on the value of a single measure of transition impact. The Hare and Normak paper concluded:

It would seem preferable to use project-level indicators as a checklist of issues needing to be explored from an early stage of project design rather than to reduce them to a single numeric benchmark, especially if the latter was merely summarising a set of not very carefully analysed ‘impressions’ about the project.

The authors did, however, recognise that differences in thinking about implementation could be overcome by seeing the matter as the start of a process of discussion amongst the relevant departments.

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13 ‘Estimating the Transition Impact of EBRD Projects’, by Hare and Normak, internal paper presented to an EBRD research conference, London, 26 and 27 April 1996, EBRD.
14 Ibid., p. 20.
16 Ibid., p. 5.
On the issue of the responsibility for assessing the transition impact of projects, they advocated avoiding increasing the burden on the appraisal process. “The main responsibility must obviously lie with the department that already analyses projects and guides them through the selection and appraisal process, namely Banking.”

The involvement of OCE, though in an advisory capacity, was seen as important, as was the contribution *ex post* of PED. This meant a heavy reliance on quantifiable (or testable) indicators of transition for which bankers could be subsequently held accountable. It also placed a premium on learning. The economists had to be willing and able to explain the transition impact system to bankers and train them on its attributes and interpretation.


By 1997, the system of project-level indicators had been tested and improved with the help of the working group and the many bankers involved. Reactions among the bankers had been broadly positive. Project leaders found the indicators and the economists’ advice on their interpretation of projects helpful for document write-ups for Board approval. Shareholders were also interested to hear management’s answers to the question of measurement of development impact, a matter that pervaded debate in other MDBs. This too encouraged the EBRD to identify its impact better. As a way of satisfying this demand a summary paper on the conclusions of the work of the previous years and the latest interpretation of the system was prepared.

Stern and Lankes presented their paper to the Board as a formal introduction of the new conceptual framework at the FOPC in February 1997.\footnote{\textit{'Transition Impact of Projects'}, 10 February 1997.}

Here, the rejection of cost-benefit analysis for project appraisal at the EBRD was made explicit.

Cost-benefit analysis is not well-equipped to handle two sets of issues which are central to the transition process: radical structural change and learning of market-oriented methods and behaviour. The reason is that the
approach ... requires an explicit model of economic structures and behaviour [and] such changes often pose insuperable challenges to the model. The transition, however, is concerned precisely with changing structures and behaviour. Thus the spotlight in the analysis of transition falls precisely where cost-benefit analysis is weakest. Transition focuses on processes rather than outcomes ... the particular problem for the EBRD in this context is that the kind of effects that cost-benefit analysis conventionally leaves out are, in fact, central to the impact of the project on the transition. And further ... the value of the processes may go beyond simply the material outcomes they produce.\textsuperscript{19}

The process of evaluating the project-level indicators had allowed Stern and Lankes to identify three broad dimensions that described the process of transition to a market economy: the creation, expansion and improvement of markets; the establishment and strengthening of institutions, laws and policies that support markets (including private ownership); and the adoption of behaviour patterns and skills with a market perspective. They argued that the transition impact of projects and related activities could be assessed in a qualitative fashion by way of “checkable stories” based on this approach, which was further broken down into seven components to form a final transition checklist, as shown in Table 10.2 below.

<table>
<thead>
<tr>
<th>1. Contributions to the structure and extent of markets</th>
<th>1.1 Greater competition in the project sector</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1.2 Expansion of competitive market interactions in other sectors</td>
</tr>
<tr>
<td>2. Contributions to the institutions and policies that support markets</td>
<td>2.1 More widespread private ownership and entrepreneurship</td>
</tr>
<tr>
<td></td>
<td>2.2 Institutions, laws and policies that promote market functioning and efficiency</td>
</tr>
<tr>
<td>3. Contributions to market-based behaviour patterns, skills and innovation</td>
<td>3.1 Transfer and dispersion of skills</td>
</tr>
<tr>
<td></td>
<td>3.2 Demonstration of new replicable behaviours and activities</td>
</tr>
<tr>
<td></td>
<td>3.3 Setting standards for corporate governance and business conduct</td>
</tr>
</tbody>
</table>

\textsuperscript{19} Ibid., pp. 3–4
The methodology introduced in the Stern-Lankes paper was a landmark among DFIs. No other institution paid such attention to the wider, systemic effects of their interventions on market processes, preferring instead to focus on the direct impact of the project itself (and some indirect outcomes like job creation). To a large degree, the approach reflected the unique circumstances facing the EBRD and its region of operations, where markets were only just forming and the focus was on the private sector rather than the large public-sector projects pursued by most DFIs. But it had a more universal applicability to private-sector development.

A further reason for the EBRD approach was the sheer number of projects the Bank pursued, mostly of small size, compared with other institutions. This, as well as the large number of equity and corporate finance deals, made sophisticated numerical calculations of costs and benefits difficult to assess for every project and of limited value, especially with a very small team of economists and limited resources for hiring consultants.

In the case of larger projects such as public-sector infrastructure, economic rates of return were calculated along with an assessment of transition impact. Stern-Lankes noted:

> The close conceptual relationship between economic rate of return, transition impact and environmental impact implies that the three should always be viewed in conjunction when assessing the benefits of a project in relation to the transition.20

They also recognised that transition impact was a function of time and context. In other words, some impacts—demonstration effects for example—may require time to take full effect, while a project in a more advanced country may have a much weaker impact on the transition than a similar one in a country at an earlier stage of the transition process. Nonetheless, in the authors’ view:

> A qualitative assessment of the strength of a project’s contribution to market expansion and learning can be made in a way which is systematically structured to inform the appraisal process [through the use of the checklist].21

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20 Ibid., p. 4.
21 Ibid., p. 6.
Now there was not only financial leverage to take into account in project assessment (the ability of the EBRD to provide finance on its own account and leverage other sources of funds, including through the mobilisation of co-financing), but also transition impact (the project’s ability to drive additional investment and change in the economy as market enhancements occurred). Talk of the Bank’s multiplier effect, which had so far been described in terms of total project finance catalysed by EBRD investment, now extended to the notion of a transition impact multiplier. In principle, the latter could be seen through progress in the country and sector context.

The new approach was complemented by a paper which applied the analytical tools to an assessment of transition impact trends in the portfolio. This covered countries at different stages of transition and an analysis of projects in the Russian portfolio (127 at the time), measured against the seven transition checklist criteria (as shown in Table 10.2). The analysis showed advanced transition economies tended to be dominated by direct corporate and private infrastructure investments, and early transition countries mainly by public infrastructure and sovereign lines of credit. Private-sector projects focused on “greater competition” and demonstration effects such as “new products and processes”, whereas state projects showed higher frequencies of achieving “greater competition in other sectors” and “improved market efficiency via institutions, laws and policies”.

This was the first time the Board was presented with an attempt at providing comprehensive information on ex ante, ex post and “on-the-go” assessments of transition impact. Complementing the OCE work on each project’s likely impact on transition was the Evaluation Department’s perspective on ex post and “on-the-go” contributions of projects in the portfolio though their evaluations of operations nearing or beyond completion. Banking teams completed the picture by providing commentary and examples of transition impacts relevant to their particular sector under each of the checklist criteria.

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23 The two most prominent transition impact criteria were identified for each project and then aggregated to show the dispersion of the criteria among private and state projects, respectively.
24 Given the relatively early stage of many projects in the portfolio in 1996, the sample was small and weighted towards “in flight” projects.
25 Sectors covered included financial institutions, property, early stage equity, transport, telecommunications, natural resources, power and energy, energy efficiency, municipal and environmental infrastructure, and agribusiness.
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It had taken a considerable effort to prepare the material—the original request from FOPC for some analysis had been made almost 12 months earlier—and it was something of a “pick’n’mix” collection of insights drawn from project documents, evaluations and observations based on bankers’ experiences. Nonetheless, the Board, through the FOPC, which had been closely involved throughout and had pushed for clarity of purpose from the start, thanked management for the “significant amount of work which had gone into the preparation of the paper”.

The episode had demonstrated three important lessons. Internally, there was a clear recognition of the importance of conducting a proper assessment of the contributions of projects to the transition process. Second, the exercise had shown a genuine willingness to collaborate between key Bank departments to achieve this goal and reach a consensus of interpretation as far as possible. Third, the extensive discussions helped to foster a corporate culture based on a mutual understanding of the twin purposes of the EBRD: to pursue commercial deals but also those which had a clear impact on moving the transition process forward.

4. Strengthening Risk Analysis in Parallel

Like most commercial banks the EBRD considered the financial risks surrounding its investments. This was particularly challenging given the many unknowns in the region. Early efforts to improve the assessment of project-level transition impact were matched by a similar strengthening of the evaluation of financial risks associated with projects. Hitherto, while working level credit analysis was good, the system was structurally weak, with an optional and consultative process on credit matters and no dedicated process to make specific recommendations. Fortunately, there had been good protection from the strong skills of Freeman in identifying key weaknesses and risks in the projects coming to OpsCom.

During the interregnum between Attali’s departure and de Larosière’s arrival at the EBRD, Noreen Doyle, an American banker who had been recruited from Bankers Trust and was in charge of the Bank’s loan syndication activities, approached Freeman, then acting President, with a proposal to improve risk assessment and give it a more formal role in the project-appraisal procedure akin to that used in commercial banks.
Doyle had some influence not only as a serious banker respected by Freeman but also as one of the three people managing OpsCom. Freeman accepted her suggestion. According to Doyle, he asked her to become Head of Credit, and to establish the Credit Department in the Finance vice presidency in order to avoid any conflict of interest. This meant credit risk assessment would no longer be “an optional stop for the bankers” but a truly independent function able to input advice to bankers on the structuring and design of projects. In this respect, the economists and credit analysts became aligned, each with a different perspective.

Doyle moved across to Finance, taking loan syndications with her, and began by setting up a credit review process in line with commercial practice. The new arrangements were soon up and running. A first step was to develop for the EBRD’s countries of operations a set of country risk ratings—which did not then exist—in line with the general approach adopted by credit rating agencies, such as Standard and Poor’s. It was followed by the creation of a group to analyse credit risks faced within the growing portfolio, and was complemented in 1996 with a workout segment that was becoming a more urgent need.

Under Doyle’s leadership several experienced and tough-minded risk experts with backgrounds in commercial banks, big corporates and IFIs were able to challenge many aspects of bankers’ deals and make ‘yes/no’ recommendations. Bob Harada, a Chase Manhattan US executive with a wealth of financial analytical skills, who had been involved from the beginning, managed the credit analysis side while Mike Williams, a deceptively soft-spoken Brit, joined a little later to deal with the portfolio. The Anglo-American group was completed by the appointment of David Klingensmith, another American from Chase, this time with experience of Asian developing country markets. All were heavily committed to establishing the credentials of the new credit risk department and helping bankers improve the quality of their deals from a risk management perspective. Freeman and Doyle also realised that for the process to work well it would need to be open and collegiate throughout, a doctrine that Freeman had established in OpsCom.

26 The others making up the OpsCom Secretariat were Gavin Anderson and Jean-Francois Maquet, both senior advisers in the FVP’s front office.
28 Credit rating agencies provided country risk ratings for the larger advanced countries, such as the Czech Republic and Hungary, in due course.
and which Doyle carried through when she later took on the FVP role and Chair of OpsCom, and which has continued since. The new arrangements provided a solid base for ensuring that the EBRD followed its principle of “sound banking” to the letter.

The strengthening of the financial risk process was an important parallel effort to advances in the assessment of transition impact during this time. Collectively, the improvements helped to embed a balanced business model in the EBRD, while the key personalities involved ensured the corporate culture reflected the substance in an open and supportive way that could deliver transition impact while maintaining financial sustainability.29

5. Operationalising the Transition Impact System: Introducing Ratings

Having won support for the Stern-Lankes approach on transition impact, the next step was to apply the methodology more formally to the EBRD’s operations. This was not a simple matter and went beyond debates by academic economists over erudite theories of impact measurement. It trod on evaluation turf but, far more important, it impacted the Banking Department directly. If the economists got their way, they would be able to define what was a “good” project and what was not. If a formal rating system was introduced, bankers might find their hard-fought deals sacrificed on the altar of transition impact as decided by economists in their conclave.

Stern well understood the risks. Since his arrival he had carefully built up the language of transition by making sure the transition context was always present in documents going to the Board, whether on projects or on policy. An articulate and smooth operator as well as a powerful intellect, he had already taken a prominent role in the Executive Committee and had the full confidence of the President. Nonetheless, keeping the Banking Department onside still represented a major task.

The trick was not to push too hard or too quickly. Stern was in any case not keen on a formal rating system believing that institutional learning takes

29 No similar formal process to test for additionality was developed at the time, although it featured in project documents and was challenged by economists in OpsCom when the need arose. It became a more relevant criterion as countries progressed along the transition path and featured prominently in the debate on graduation. See Chapter 12.
time and persistence. Achieving a deep understanding of the importance of transition impact and building that into the corporate culture could not be done overnight. In this context, a formal rating system ran the risk of putting an undue focus on the score and could distract attention from the underlying substance behind the assessment. Just as cost-benefit analysis could be overplayed in the transition context, it was also important not to take the transition impact analysis beyond its limits. Besides, there was much for the EBRD to do in the region, so ruthless prioritising of projects was not yet called for. What was needed was a clear understanding of what the Bank was trying to achieve through its projects and other work from a public purpose perspective.

It was a fair concern that a summary characterisation of transition impact or a label might imply over-precision. There were risks in trying to compare the incomparable and measure the immeasurable. A project’s impact depended heavily on the context and many qualitative factors that were difficult to compare across sectors and countries. On the other hand, a summary overview of a project’s impact might be more acceptable if risks to the delivery of that impact were added to the picture. This could help to pin down the degree of uncertainty over the assessment of the likely outcomes. Recognition could be given, for example, that the impact on transition of the Bank’s interventions was likely to be greater where reforms were underway than in cases where they were not. Conceptually, the system thus evolved to consider both the potential impact of a project on transition (using the checklist) and the risks associated with the delivery of the specific impacts identified.

On the Banking side, there had been a general awareness for some time that there was no real coherence in describing how projects were aligned with the EBRD’s mandate and that more discipline was needed. The indicators helped and the idea that transition impact should fit into a consistent and verifiable framework (described at the time as “checkable stories”) was regarded as useful.

Some felt that the use of a summary label for a project’s impact could be helpful depending on how it might be used. Aggregating the indicators to provide an overall assessment was a way of cutting through the many dimensions behind a project and would force those involved to think through their case and justify their position. A more prominent focus, which a summary rating would surely bring in the view of some OpsCom members, could help pose the right questions and elicit more clarity from bankers.
Senior managers were aware that a labelling or rating system might lead to disputes. On the other hand, it would flush out disagreements and OpsCom was there to resolve any problems. It was particularly important for management to resolve these issues before projects went to Directors for approval. There should be no risk of public disagreement in the Boardroom. For this reason, a move towards ratings had some management value. If some sort of ordinal ranking was introduced with fairly wide boundaries and undue weight was not placed on it—then, the thinking went, why not?

Moving in the direction of an overall classification system based on the indicators was hard to resist. Transition indicators were already being used to justify projects, so a rating was not a huge step to take. There were reasons too why a rating system could prove useful from a Banking perspective. For one thing, it could make it easier to allocate resources to more difficult transition regions, which management was under constant pressure from the Board to do. These areas were labour-intensive and less attractive to bankers since they were time-consuming to travel to, often involved small deals and were more troublesome when it came to conducting business. Recognition of the higher transition impact potential (albeit with higher risks) in these areas would encourage bankers and be a useful signal to the Board of the seriousness of the EBRD’s intent when pursuing such projects, especially when combined with a mantra of seeking to pursue transition with full vigour.

Ratings also helped to indicate the quality of projects and thus added a different dimension from volume, again something Directors were keen to understand better and for the Bank to improve upon. From the Bank’s perspective, ratings also helped—seemingly paradoxically—in central Europe. While weaker transition impact projects were at risk of criticism here (although often saved by lower financial risks and more attractive returns), projects classified above average (“good” or “excellent”) offered a way to demonstrate that transition “gaps” remained even in more advanced countries and that the Bank’s investments could make a difference.

Although in its initial form the transition impact methodology had eschewed making comparisons between projects in favour of qualitative assessments and “checkable stories”, the Board also saw value in pushing further towards ratings, including as a means of holding management to account for the Bank’s contribution to the transition process. The heavy concentration of EBRD business volume in central European countries which were more
advanced than other EBRD regions had begun to draw adverse attention from Directors. Some form of differentiation between projects thus had advantages for those Directors advocating that the Bank shift resources away from central Europe towards more difficult activities and countries where transition was weakest. Further yardsticks to help prioritise activities were seen as useful and a project rating system fitted the bill.

Around the time these matters were being discussed, Freeman left the EBRD to return to Salomon Brothers. His successor, Charles Frank, took over as FVP in September 1997 and became acting President following de Larosière’s departure in January 1998. His arrival coincided with the emerging conclusions of the Zero Base Budgeting (ZBB) exercise designed to look at the Bank’s operational model, simplify its systems and processes and raise productivity.\(^\text{30}\) The initiative had begun during Freeman’s tenure as FVP but he had not taken much notice. Frank was more familiar with and interested in business management systems than his predecessor and saw scope to speed up decision-making and strengthen the operational mechanics. A project transition impact classification and rating system fitted this general philosophy, so in 1998 the economists tested with Banking, informally at first, a light classification system for concept reviews which involved summary categories on transition impact potential and risks to that impact.\(^\text{31}\)

As part of the process the OpsCom system was tightened further, including dividing the agendas between important or difficult projects and the rest.\(^\text{32}\) Members were encouraged early on under Frank’s chairing of OpsCom to concentrate on their own specialisms. There was a push to make project documents more succinct and tighter procedures were developed, whereby the key non-Banking parties around the table—the credit analysts, economists, lawyers and Treasury/syndications representatives—would submit fully articulated notes of their positions on bankers’ project proposals ahead of the OpsCom meeting. Frank took issue with the lawyers having a say in approving projects as opposed to simply fulfilling a compliance function in relation to the Articles. Freeman had been very happy to have lawyers present at OpsCom to discuss transactions (partly due to his own legal


\(^{31}\) Labels of “high”, “medium” and “low” transition impact were used at this stage.

\(^{32}\) This was an A/B list in which only A projects were fully discussed with the relevant banking team in front of the Committee. ‘President’s briefing to the Board of Directors on Zero Base Budgeting’, 18 September 1997.
training), but Frank came from GE Capital where, as was normal in such investment banks, external counsel were hired by bankers to assist with their transactions. A battle over the role of EBRD’s legal staff in the Bank’s operations ensued, which was eventually settled with the General Counsel and his representatives remaining active participants at OpsCom, and they remained in charge of all instructions of outside counsel.

Further changes to EBRD procedures were on the cards when Horst Köhler, a former State Secretary at the German Federal Finance Ministry and a G7 deputy, arrived as President of the EBRD in September 1998. Like his predecessor, he began by asking staff to review the Bank’s operational priorities. This was all the more necessary since Köhler’s arrival coincided with the Russian debt crisis (see Chapter 11).

Stern was once again in the driving seat but this time with less freedom of manoeuvre and it was not long before his interest turned to finding a new role outside the Bank.33

Following a discussion at a Board retreat in January 1999, the review of priorities was issued as a short paper.34 It reaffirmed much of the previous approach, including strengthening local presence and encouraging start-ups and SMEs, but laid a new emphasis on a strategic approach to portfolio management. This recognised the need to balance transition impact, financial returns and risk, and led to a tightening of procedures all round.

As part of the response to the portfolio-management approach, Stern announced in May that OCE would in future formally provide its ratings of transition impact potential and risks in its notes to OpsCom.35 He explained that transition impact potential would be defined through reference to the checklist categories and the sector-relevant versions. Ratings were to be based on an ordinal scale with broad categories ranging from “unsatisfactory” to “excellent”.36 A similar approach applied to risks, with a range from “excessive” to “low”.37 Here risks to transition impact depended both on the

36 The Evaluation Department had been using a classification system, albeit a different one, for some time for completed projects (unsuccessful to generally successful) so the introduction of a similar one for ex ante assessments was not altogether alien.
37 The categories used for transition impact potential were “unsatisfactory”, “marginal”, “satisfactory”, “good”, “excellent” and for risks were “negligible”, “low”, “medium”, “high” and “excessive”.
likelihood that the transition impact potential would not be realised and on the risk of negative impact deriving from certain attributes of a project (inappropriate subsidies or protection for example). Stern pointed out that, while financial risks could be relevant to transition impact results, transition impact risks were generally separate and different in nature, pertaining to whether the impact argued for—such as higher standards, demonstration effects and so on—would likely occur.

From then on, assessment was made using ratings and the transition impact methodology (that is, based on the checklist and transition context), with typically two of the seven criteria to describe the impact of the project. Once OpsCom had become familiar and happy with the system, it was extended to project documents presented to the Board from mid-2000. This gave Directors a basis of comparison and a view of management’s thinking on the (relative) transition value of the operation.

6. Tensions Build

Early misgivings on a “hard” rating system by the well-respected Chief Economist were tempered by a feeling that greater clarity of purpose to projects under a rating system was a reasonable objective. Banking had thus not viewed the introduction of a project classification system and ratings as a source of internal complications. They knew in any case that “satisfactory” projects would still go to the Board for approval and were highly unlikely to be rejected there. Lower-classified projects (“unsatisfactory” or “marginal”) rarely made it as far as OpsCom.

Over time the pattern changed. The increased prominence of transition impact in projects and its calibration throughout each stage of their development meant the economists’ role in OpsCom became much more significant. Originally, the Chief Economist had not been a member of the Committee but this changed after Stern’s arrival. From now on, OCE representatives were a focal point for opinions on transition impact value.

Although “satisfactory” projects were eligible for presentation to the Board, they inevitably invited increased scrutiny and questions from Directors as to whether they really were up to the mark or whether some fudge had been applied to get them “over the line”. Team directors and operation leaders who faced Board scrutiny naturally preferred to avoid such ques-
tioning if possible, so these pressures fed back through the system to debates with economists over the transition merits of the project. OpsCom was the place where the most serious disagreements were resolved (except in the most strategically significant disputed cases where ExCom was needed). Hence the Chief Economist and representatives from OCE had a critical influence in steering the direction of the EBRD’s operations.

Other factors strengthened this development. Turnover in the Board was rapid so earlier discussions were quickly forgotten, while changing personalities here, in OCE and elsewhere led to different emphases. A big influence was the progress of some countries, which led to a more serious questioning of the validity of projects’ incremental impact and additionality. The rapid build-up of new projects, several of which repeated earlier transactions—either the same type of project or with the same client—also caused controversy. And in this context some in OCE were keener than their predecessors to exert greater control over projects coming to the Board for approval.

The issue of what new systemic impact projects provided became more difficult to explain for the more advanced countries, particularly in repeat projects. Such operations were increasingly common and the ratings provided by the economists often fell below bankers’ expectations. As bankers saw it, their operations fostered the transition process in various ways, mainly by helping a client to make competitive changes in difficult circumstances where reasonable financing terms were unavailable and local entrepreneurs still few and far between. Meanwhile, the economists wanted to see innovative products and processes introduced and path-breaking market improvements from changed behaviours and strengthened institutions. A wedge began to appear between the two perspectives, made worse by the fact that bankers used to writing their own scripts were subject to an *ex ante* independent assessment of their efforts (and not simply one *ex post* from the Evaluation Department).

The new Chief Economist, Willem Buiter, an eminent Dutch-born Cambridge professor of international macroeconomics, participated regularly in OpsCom following his arrival at the EBRD in 2000. Buiter was a formidable intellectual economist and combative character, unique in style, insightful and highly entertaining. He was regarded as something of a maverick.\(^{38}\) His views on projects were often very direct or amusing. In one in-
stance, according to EBRD economists present at the OpsCom meeting, he questioned a “nice” project, likening it to a “nice” chocolate pudding which nonetheless did not have any transition impact. Such metaphors clashed with bankers’ views on projects. The economists, however, were pleased that OCE’s position was represented with exceptional clarity and in a “no nonsense” demeanour.

When Lankes left the Bank for the IMF later in 2000, several months after Köhler’s rapid departure to become the new IMF Managing Director, José Carbajo became the OCE director in charge of project assessment and submissions to OpsCom. As part of the work that had been set in train across the Bank on the portfolio approach, he developed a transition impact monitoring system (TIMS)39 with Buiter’s support to cover the transition dimensions of the stock of projects.40

It was now possible to trace the path of a project’s transition impact performance from beginning to end. The rating at the start, based on the context, the project’s contribution and specific performance benchmarks—say, “good” potential with “high” risks to delivery—could now be tracked through to a final result. If, say, after two years the project was on track, the transition risk rating might be adjusted down to “medium”, while if at the end some but not all objectives were met, the final impact rating might be recorded as “satisfactory”. (Risks at this stage would be “negligible”.) This meant it was possible to see both the position of transition impact ratings for new projects and how the existing stock of projects was faring, thus providing an overview of the whole of the EBRD’s activities under this dimension. There was now a metric for transition impact that could be discussed in a similar vein to profitability and risk, as targeted under the strategic approach to portfolio management.

It was not long before a further change was made that had a significant effect on behaviours and interactions between bankers and economists. This was the introduction of a corporate scorecard41 in 2001, which included among a number of targets a category for transition impact based on project scores. Initially, two-thirds of projects were required to be rated “good” or better. The target became more precise in due course—although

39 Kjetl Tvedt, an economist in OCE, was also closely involved.
40 A full account of the system can be found in J. Carbajo and Z. Kominek, ‘Managing for Results: A decade of project-level impact assessment at the EBRD’, EBRD, 2010.
41 Thinking along the lines of a scorecard had been under consideration for a while. See Chapter 12.
never so tight that the EBRD was unable to meet it—and was integrated into bankers’ individual objectives and incentives. Over time, various refinements were made to the scoring system, including the addition of a risk-based version, expected transition impact, and a related target for progress in the portfolio. The principle of targeting transition impact as a core component of the Bank’s performance (with a high weighting in the scorecard), and that of its bankers, has survived to the present day.

There still remained the question of how to achieve a suitable balance between transition impact, financial returns and risks as envisaged under the strategic approach to portfolio management. The potential conflict between transition impact, as espoused by economists, and financial returns, as sought by bankers, and risk, as focused on by credit officers, needed addressing.

This was the job of OpsCom. The balance between financial risk and return was resolved very much in the same way as in commercial credit committees, namely through a process of negotiation to find a suitable tolerance level. On transition impact and returns, the picture was a little different. In most private-sector projects, there was little conflict between the objectives: restructuring a company to become profitable, for example, normally went hand-in-hand with strengthening its competitiveness or improving its corporate governance (both of which were acceptable from a risk perspective).

The exceptions were when subsidies, protection or exploiting monopolistic aspects of markets came into play and profitability (or the reduction of financial risk) was achieved by supporting market distortions. In public-sector projects there would typically be alignment over tariff-setting improvements and similar conditions, but not when state market power was abused, where there was a lack of reform or when profits were made from supporting an unreformed state entity.

Of course, at the margin a little more push for transition impact (for example, via an extra covenant) might be traded for a little less risk-adjusted financial return (the client might argue for reduced pricing). But the reality of most projects is that discrete elements apply and negotiations take place over many aspects, so such fine trade-offs were difficult to find. Where they were more likely to be found was at the early selection stage when projects chosen for their best commercial profile need not match those selected on transition grounds.

As the transition impact rating system bedded in, the competitive nature of private-sector bankers inevitably began to permeate the system.
“Excellent” ratings were sought from the arbiters of transition impact, the economists, while “satisfactory” ones were often disputed. The independent role of the Chief Economist meant the view on transition impact, like a legal opinion, could be challenged. Once a judgement was given, however, it could not be overturned. The “creative tension” between bankers seeking sign-off on their deals and economists eager to ensure they served the transition process well and were additional meant focused debates took place on nearly every project.

The practical needs and detailed project and local knowledge of the bankers became pitted against the wider, more conceptual perspective and methodologically consistent approach of the economists. Some bankers cynically complained that the economists were the “high priests of transition” while the economists saw the bankers as volume and deal-driven to the exclusion of anything else. The truth was different, as less excitable observers acknowledged.

Bankers realised that the nature of the EBRD meant it was different from a purely commercial organisation and that they could not ignore the mandate. Close involvement with the sector economists on projects was the simplest way of understanding the transition dimensions better and getting help and buy-in. The economists for their part accepted that being based in EBRD’s London headquarters limited their understanding of requirements on the ground, the reality of trying to persuade clients to accept transition-related covenants (clients had far less understanding or patience on such matters than even the bankers), and the true difficulties of overcoming local constraints and making progress with the authorities.

Gradually, the economists became more embedded with Banking teams. The process of discussion of projects from their initiation to final review between the two departments, and its evolution and learning by doing, helped to form a real understanding of the nuts and bolts of transition impact and the ways in which the Bank could influence the process. As a result, a “transition impact culture” was fostered within the institution—something that became apparent to new recruits within moments of their arrival.

The Board offered its own view on the transition impact judgement in projects and more often than not took the Chief Economist’s decision on this dimension as the correct interpretation—although this did not prevent Directors arguing with the ratings given to particular projects.
7. A Coherent Business Model for a Private Sector-Driven Public Institution

Both the OpsCom exposure and that at the Board meant the language and sources of transition quickly became assimilated into bankers’ thinking. The consensus-driven nature of the OpsCom and Board discussions helped to avoid undue stand-offs and led to a better internal understanding of transition impact than might have been expected (notwithstanding many lively discussions and hotly contested arguments). For new bankers, used to difficult discussions at credit committees over the pricing and structure of their projects, it was a shock to be confronted with a similar committee questioning the value of their deal on the basis of whether it added anything from the transition impact point of view. They had to learn fast, and by and large did.

The establishment of “transition impact” as a core feature of the Bank and its activities took some time to become firmly embedded in the institution. Like many aspects of the EBRD’s persona, it evolved through a competitive process within a collaborative context as the Bank grew and matured and sought to place itself among its IFI peers. The EBRD’s methodological approach reflected the fact that the Bank was serving a different purpose: establishing the transition to functioning markets as a commercially orient-ed bank with limited donor funds, as opposed to improving social outcomes with donor support, guarantees and repeated capital replenishments.

The debate about transition impact was largely an internal matter (although discussed in publications such as the Transition Report). Nonetheless, its operationalisation was of significance, not only to the EBRD in driving it forward in a more focused and relevant way, but also because the institutional mechanism for incorporating this alternative currency to financial returns carried wider implications, including for other organisations seeking to achieve multiple targets. The Bank found an effective way of squaring the two key purposes of the institution and embedding them on an equal footing in the conduct of its operations: on the one hand optimising its resources to deliver its mandate on transition, while on the other ensuring it remained a financially sustainable enterprise. Assessment of transition impact implicitly provided a means to measure the rate of return to the public purse—its development capital—while profits after provisions could help to deliver an adequate rate of return on its financial capital.