

## **EVD SPECIAL STUDY: EBRD'S RESPONSE TO THE 2008-2009 CRISIS**

### **MANAGEMENT COMMENT**

Management welcomes the analysis in EvD's timely Special Study on EBRD's Crisis Response. It agrees with the direction of most of the analysis and findings; in the majority of areas the actions of the Bank closely mirrored the recommendations and lessons learned highlighted in the Report.

For ease of reference, the Management Comments are made in relation to the lessons learned and recommendations set out in section 6 of the Report; the comments also apply to the relevant sections of the previous chapters whose analysis underlies these findings.

In sections 5, 6.2.3 and in Appendix 2, EvD raise broad issues about how the Bank reviews country risk and vulnerability, and the link between this analysis and business planning and exposure limits. This is an important area encompassing a number of related themes. Management comments on these aspects are therefore dealt with separately in section 2 below.

#### **1. Response to recommendations in section 6**

##### *6.1 (Structural constraints on crisis response, increased volume vs. restructuring, and crisis response preparedness)*

Management agrees that its mandate and skill set impose structural constraints on the way in which it can respond to economic and financial crises. While there are circumstances in which it can act at a systemic level (as in the Vienna initiative), its interventions need to be based on case-by-case assessment of individual client needs, as section 6.1.1 explains.

Management does not see a trade-off between focusing on delivery of increased volume vs. restructuring of existing client loans. Both activities have an important role to play. One indicator of the level of rescheduling and restructuring required is the increase in Corporate Recovery work load during the crisis period. However it is important to note that in addition to the severe restructuring normally entailed in a workout supervised by Corporate Recovery, there was a very significant lower level restructuring in the Bank's portfolio (e.g. agreement to reschedule payments within the existing loan maturities in order to accommodate short term liquidity shortfalls in sound businesses). For instance in 2009, there were over sixty such cases agreed outside the Corporate Recovery portfolio.

The way in which the Bank responds to a future crisis will of course depend on the nature of that crisis, just as the response to the 1998 crisis was very different from the current one. Management agrees with EvD that part of the key to this response is whether individual client issues represent liquidity or solvency problems, and that it can be difficult to distinguish between these situations at the early stages of a severe crisis. The determinations can in the end only be made case by case, and this is where the Bank's project-based mandate and skills are particularly relevant. Even where clients face solvency problems, the Bank may be able to act to assist, but only when recapitalisation takes place on the basis of a realistic future business plan and appropriate write-down of the existing capital position to reflect risks which have

materialised. For client/project level responses the set of instruments available to the Bank proved to be fully appropriate.

The EvD suggestion to reserve capital and liquidity for an increase in risk and volume in response to a crisis is a sound one. The Bank's economic capital planning framework is designed to include stress tests which reflect the potential impact of a severe crisis in the future. The lessons to be learned from the form which this crisis took have been reflected in the nature of these stress tests. The specific suggestion to reserve capital for an increase in volume in response to a future crisis does not have short term planning implications given the nature of the business volume and capital utilisation projections contained in the CRR4 documents. This recommendation could however be relevant to discussions in later planning periods, and Management does expect that there will indeed be capital available to function as a reserve of this sort.

In terms of planning for future crises, the capital aspect discussed above is key. Beyond this aspect, it is unlikely to be effective to plan for responses to potential crises beyond a 12-month period ahead. This is because the specifics of the Bank's mandate and its region mean that action plans based on speculative scenarios are unlikely to be relevant when a specific response is needed. Regarding the shorter term planning horizon, it will be most effective to incorporate relevant thinking into the business plan and budget process; indeed discussions with the Board have in the past referred to various adverse scenarios and their potential impact on the Bank's business profile.

An example of how country strategies, business plans, and projects can be adapted to address the vulnerability of countries of operation to prevent risk is the local currency initiative which has been discussed with the Board. While in this case there is much that the Bank can do, other potential areas of intervention to reduce country of operation vulnerability may not lend themselves to projects within the Bank's mandate or comparative advantage in relation to other IFIs.

#### *6.2.1 (Maintaining capital strength before and during the crisis)*

Management agrees on the importance of ensuring that any changes in interpretation of capital-related principles are accompanied by clear presentation of the implications for business planning scenarios both under new and old interpretations. Management sought to explain the implications of the change in the interpretation of capital utilisation parameters on this basis through the documentation by which the Board approved the changes. The EvD report focuses only on the demand factors which fed into discussion of the change in interpretation of the gearing ratio. However it is important to note that there had already been concerns over a long period about the interpretation of the gearing ratio in terms of ensuring capital efficiency, starting with the discussion with the Board in the Capital Utilisation Technical Review exercise in 2004. In anticipation of a possible capital increase, the Board and Shareholders were right to expect that the Bank should first pay attention to fully efficient use of existing sources of capital.

#### *6.2.2 (The crisis revealed unexpected differences among COOs)*

Management agrees with the findings in this section. The Bank's system of country risk analysis and classification has been designed to respond to the issues raised by EvD in this and related sections of the EvD report, and does reflect the experience of how differences in country vulnerability translated into crisis impact over the last two years.

The comment about the respective roles of OCE and Risk Management in forecasting, vulnerability analysis and risk rating is addressed in Section 2 of this Management Comment below.

#### *6.2.3 (Country-level vulnerabilities and limits to country exposures)*

Management believes that country risk, trigger and limit system continues to be fit for the purpose, after successfully guiding the Bank through the Russian crisis of the 1990s and current global financial turmoil. More detailed feedback on the proposed recommendations and the related analysis in other relevant parts of the Report including Appendix 2 is outlined in section 2 below.

#### *6.2.4 (Business cycle and credit risk)*

Management agrees that an ideal position could in certain circumstances be to reduce credit exposure during the final phase of a credit cycle if it is marked by continued strong private sector credit appetite, and then to re-enter the market more vigorously to finance sound businesses when private sector appetite may evaporate during periods of exceptional credit restriction at the start of a crisis. (This assumes sufficient flexibility in business planning and institutional targets). There are however two difficulties in achieving this ideal in practice, one which applies to any bank, and another which is relevant particularly for a publicly owned IFI.

This strategy should in theory be advantageous for any lending institution, whether public or private. The issue is however how to predict accurately in advance when the market is truly in the final stage of a credit cycle. This is relatively easier to do in relation to individual segments of the market. EBRD did for instance reduce its lending in certain areas (e.g. real estate developments in capitals). With hindsight, the Bank has also recognised lessons related to forex lending to certain country financial sectors which experienced unsustainable credit booms, lessons which are now reflected in the local currency initiative.

It can however be harder to distinguish cyclical vs. structural changes at a wider level, whether in terms of an overall country credit cycle or a regional/global cycle. Central Banks, for instance, whose mandate is to focus heavily on such issues, have not found this easy in practice.

For a public sector IFI, there are additional issues. Given the transition mandate of the Bank, it is not clear that shareholders will necessarily support reduced activity based on projections of potential crisis developments which may or may not materialise. This is all the more the case if a severe crisis is not being predicted by the government forecasts and Treasuries in the capitals of shareholders or by the IFIs with a mandate for international economic stabilisation. Shareholders might instead take the view that the Bank should continue to grow in line with activity levels representing shareholders' objectives for transition and the Bank's overall profile in the region. The increased risk of future losses might be deemed acceptable, provided that the individual projects continue to meet the Bank's normal approval criteria, and that capital utilisation analysis shows that the Bank has sufficient statutory and economic capital to withstand relevant downside scenarios. It should be noted that the Bank's capital increase was required not in order to absorb potential losses on the existing portfolio, but in order to accommodate an increase in lending volumes following the onset of the crisis.

The comment in the last line of section 6.2.4 on country-level volume targets is addressed in Section 2 below.

### *6.3.1 (Bail out vs. work out)*

Management agree that this is a key issue; it is related to the judgements on whether individual client issues are problems of liquidity or solvency – see response to section 6.1 above. There are arguments that prevention of a widespread collapse may sometimes require state authorities to engage in forms of bail-out, but EBRD's particular mandate and instruments do not equip it to be part of such efforts.

### *6.3.2 (Mitigating crisis impact on banks and SMEs; risk-sharing facilities)*

Management agrees that the contraction of bank lending reflected not just availability of funding which can be mitigated through credit lines, but also willingness to lend. It also agrees that risk-sharing facilities can play a role to stimulate lending in such circumstances. Indeed the MCFE risk-sharing facility has been expanded during this crisis period. There are practical problems to “scaling up” a facility like the MCFE for use with large banks who may not face single obligor limits as acutely as small banks, but who may have a more general concern to deleverage and scale back lending. One issue is that larger banks tend to have limited demand for the product as they wish to choose which lending risks they will continue to take, and then take 100% of that risk (i.e. their choice tends to be 100% or zero, rather than a desire to share risk with another institution). There is in addition an issue of avoiding adverse selection for EBRD under such schemes with larger banks, and finally problems of agreeing appropriate pricing (where the lending business may be cross-subsidised by other lines of business enjoyed by the lending banks). In general, EBRD has had success with risk-sharing programmes focused on specific business areas where banks have a particular motivation to share risk. Broader based programmes have been less successful.

### *6.3.3 (Speed of delivery of CR projects)*

Management agrees that in the case of financial sector lending, the “signalling” effect of the availability of credit lines may often be as important to the client as actual availability of funds, where a short term liquidity shortage is subsequently reversed. However where these same banks are nonetheless restraining lending in order to deleverage and adjust balance sheets, liquidity concerns can remain severe for the real sector as these banks' clients still face restricted access to funding. These real sector projects address both recovery needs and immediate liquidity needs.

### *6.3.4 (Crisis response project eligibility criteria)*

Management generally agrees with the analysis in this and the related section of the report. It should be noted however that the fortnightly Crisis Response reporting to the Board did provide a clear and transparent flow of information to the Board on which projects were considered to be crisis response and which were not.

### *6.3.5 (Pricing of crisis response interventions)*

The Bank sought to apply the principle of “pricing through the cycle”, and thus to avoid excessive reliance on potentially unreliable indicators of market pricing, including thin CDS markets. The general principles applied are indeed in line with the formulation in the EvD lesson learned. Pricing structures do sometimes include step-ups and step-downs to adjust pricing in relation to specific events relevant to the client's risk profile. However these will not be appropriate in all cases, and in any case may not reflect more general market conditions. Pricing adjustments therefore do depend on case by case consideration. Management remains active, including in recent months, in adjusting

pricing either in response to client requests or in other cases on the initiative of the Bank in order to pre-empt potential requests.

#### *6.3.6 (Deepening the supply of local currency financing)*

Management agrees with the analysis, and the local currency financing initiative discussed with the Board is designed to respond to these concerns.

## **2. Country vulnerability and associated risk management**

Section 6.2.3, Appendix 2 and related parts of the report address a range of issues related to assessment of country vulnerability and the Bank's response in terms of risk management.

Management's view is that the EvD analysis here requires more detailed comment because some key elements of the Bank's current approach do not emerge clearly from the EvD report, but are central to a review of the issues concerned.

In summary, EvD's analysis in this area rests on the following points:

- (i) The Bank has a clearly articulated approach to country vulnerability analysis, country risk ratings, and country review triggers;
- (ii) However these tools did not lead the Bank to predict the scale of the crisis which developed;
- (iii) The Bank had significant country concentrations in Russia and Ukraine before the crisis, and these were aggravated, particularly in the case of Ukraine, by the Bank's crisis response.
- (iv) EvD does not see the country risk trigger system as having had a detectable impact on business plans and overall country exposure levels.

Management's response to these concerns requires a discussion of the Bank's current approach to the following four issues:

- (i) Assessment and recognition of vulnerabilities at the country level;
- (ii) Single country exposure concentrations; and
- (iii) The Bank's response to identified increases in vulnerability and risk in particular countries.

#### *Country risk assessment*

It is important to clarify a number of points in relation to the Bank's approach to assessment of vulnerability at the country level and the Bank's approach to country risk rating, which may not be clear from the discussion in the EvD report:

- The Bank has always been clear that its country risk ratings are based on a combination of (a) macro-financial, (b) business environment and (c) political risks, faced by an economic agent operating in a country. As such, they have been always distinct from sovereign risk ratings provided by external rating agencies. In Management's view these cover a wide range of indicators which are relevant to vulnerabilities in crises or other situations, and respond well to the type of concerns which EvD argue such systems should address, based on the lessons of the recent crisis.

- The change introduced in late 2009 was to present more clearly these elements of the risk rating and therefore to formalise, but not change, the previous approach to assessment. At the same time a parallel sovereign probability of default rating was introduced (as required by development of the Risk Management Systems Programme (RMSP)).
- There is already a well established process of vulnerability assessment which is reflected in the quarterly reports prepared by OCE (QVA), and this underpins the country risk rating assessment. In 2009, the risk assessment framework was revised so that all countries had to undergo a mandatory review on a quarterly basis in the context of the QVA report prepared by the OCE, in addition to ad hoc reviews that may be triggered by fast changing macro-financial, business environment or political conditions.

The Bank does therefore manage its assessment of country risk through “focusing on vulnerability to possible events” and the capacity of our countries of operation to withstand them. Management does not see a conflict between the responsibility for assessment of economic vulnerability and the responsibility for producing single point forecasts (see EvD point in section 6.2.2). Clearly single point forecasts do not capture a range of outcomes, but EBRD does enhance these with assessments of wider bands of potential future outcomes in different scenarios, and OCE has the knowledge base and skills required for all these types of assessments. OCE then work together with Risk Management in producing the country risk ratings and recommending changes to them.

A separate question from the adequacy of the framework itself is whether the Bank was in practice able in the run-up to the crisis to apply sufficient foresight and analytical skill to be able to react to signals in downgrading country risks. Notwithstanding the failure to pinpoint the exact timing and magnitude of the economic collapse, Management believes that the Bank has done at least acceptable job on both accounts. Firstly, the QVA reports, main tool for the macro-economic assessment by the Bank, clearly highlighted the built-up of vulnerabilities ahead of the crisis and then correctly identified significant risk of spill-over to the countries of operations after the turmoil started on mature markets (the “gravity defiers” discussion in September 2008). Furthermore, by March 2009 the Bank was in position to calibrate the breadth and depth of the recession and adjust its central forecasts accordingly, as highlighted by regional projections published in early May (and based on April data) which put forward 2009 GDP contraction in the region at 5.2%, almost equal to the 5.5% fall eventually observed for 2009.

The pace of country rating revisions has been broadly comparable for the Bank and external rating agencies in all three phases of the crisis identified in the Report, with the Bank being slightly faster on the upgrade and slower on the downgrade. The Bank ratings have been consistently more conservative throughout the crisis, based both on their broader definition (inclusion of business environment and political risk rather than pure sovereign risk) and more explicit recognition of building up weaknesses.

#### *Large country exposures*

It is true that the Bank has long had a significant single country exposure arising from its Russian portfolio, and as the EvD report notes, Ukrainian exposure increased during the run-up to the crisis and in the crisis response at a time of increased country risk. Discussion of these and other concentration issues is handled through the Quarterly Risk Reports, which note mitigating factors including portfolio diversification within the

country. These issues are also reflected in the Bank's capital utilisation and sufficiency analysis (see final paragraph of this Management Comment). However, as a regional development bank with some large countries, the Bank inevitably faces greater country concentration than, say, the IFC which is able to diversify across the full spectrum of developing countries across the world. The Bank's position is more similar to that of IADB with a relatively small number of countries including some large ones.

*Bank response to increased country vulnerability; country limits*

In section 5 and in sections 6.2.3 and 6.2.4, EvD raise questions about what effort EBRD could make to reduce country concentrations (particularly in Russia and Ukraine), in what circumstances increased country-level vulnerabilities should lead to a detectable impact on business plans and volume targets, and potential "trade-offs" between sound banking and country-level volume targets for transition impact and other strategic purposes.

Management believes it is important that this discussion is framed in the correct way. It is indeed part of the Bank's "raison d'être" to be able to take and manage risks which private sector banks are not able to take; country risk and related vulnerabilities are an important element in those risks. The issue is therefore not so much a trade-off between pursuit of the transition mandate and sound banking or appropriate risk diversification. Instead it should be clarified that the Bank's role is indeed to pursue its mandate through transition-intensive projects, if necessary in countries of increased vulnerability, and to do this in a way in which its risk management policies are respected. It is a question of "both/and" not "either/or". As the vintage analysis in section 5 of the report clearly shows, at a time of crisis this did indeed lead the Bank to significantly increase its exposure to vulnerable countries, and to increase certain measures of country concentration.

The issue is not to explore theoretical trade-offs between these objectives, but to assess whether the Bank has the right tools to carry out the required analysis that its risk management policies are respected. In Management's view it does have the required tools. The system of country risk assessment has already been discussed above, but further comments are made below on the Country Credit Review Trigger system and on the overall approach to capital utilisation and sufficiency.

The absolute limit for single country exposure is enshrined in the statutory Portfolio Risk Management and Investment Policies documents of the Bank (90% of capital). While this limit is much higher than prudent commercial practice would dictate, the Bank is not a commercial institution but an international financial institution tasked with taking on risk in transition economies. The Country Credit Review Trigger system has then been designed to assist Management and Board in their decisions on *individual project* engagement and point towards incremental concentration and commercial risks that the Bank exposes itself when taking action. The system allows flexibility and conscious risk taking in times of prosperity and crisis and guided the Bank both through the Russian crisis of the late 1990s and the most recent global financial crisis. The system was discussed in detail with the Board at an Information Session in July 2002.

It should be noted that in the case of Ukraine, this project-level process was supplemented by explicit discussion with the Board on the overall country portfolio and pipeline given the country vulnerability which was evident after the onset of the crisis. The plan to increase exposure at a time of increased vulnerability was endorsed by the

Board as fulfilling the mandate, while respecting appropriate management of the risks involved.

At an overall *Bank-wide portfolio* level, the project-level assessment has to be supplemented by the broader analysis to confirm that the Bank's capital is sufficient for the level of risk to which it is exposed, given its current and projected portfolio, taking into account current vulnerabilities which are evident, and the potential future downside scenarios. The Bank has a well-established methodology, fully discussed with the Board, for conducting economic capital tests including a range of stress tests representing potential downside scenarios. The approach to these tests and their results were fully discussed with the Board in the preparations for the capital increase and the CRR4. These tests strike a balance between broad macro-economic factors and country specific risks in the region of Bank's operations to project capital necessary to fulfil the Bank's mandate and objectives set for the capital resource review period. Although no analytical tool of this type is perfect and captures all possible scenarios, Management continues to believe that the approach applied during CRR4 discussions - and more broadly throughout the first two decades of the Bank's operations - remains sufficiently comprehensive and fully adequate for the assessment of capital utilisation and sufficiency.