# RUSSIAN FEDERATION

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Throughout its existence, the EBRD has developed a business model which focuses on supporting the private sector and commercially oriented public enterprises. In the past, this business model has been able to assure the Bank's stable financial position.

Recently, however, we have witnessed the Bank's deteriorating financial position and development prospects. Although the formally reported figures look positive, they conceal a whole series of negative trends and management assumptions. Maintaining the current approach to operations will make the Bank's position unsustainable in the coming years, might lead to a credit rating downgrade and could require a capital increase. We should focus on the following:

1. **Long-term unsustainability of the profitability of the Bank's operations.** According to the official financial report, the Bank's total income is €1.699 billion. However, it is clear that the level of profitability quoted is not of a sustainable nature for the following reasons:
   - (i) Almost a third of the Bank income has been generated in Russia. It is good management practice to demonstrate performance without including what are termed "discontinued operations", since it is clear that the absence of operations in Russia in the coming years will result in that indicator falling to zero. Without accounting for Russian operations, the Bank's actual income was only €1.202 billion.
   - (ii) Based on 2016 figures, the Bank's recorded its worst realised income in the past 5 years (€642 million).
   - (iii) In the Bank's income structure, over €200 million in the category "other operating income" results from the one-off effects of options and hedging operations, and of the revaluation of the existing portfolio.
   - (iv) According to the business plan for 2017–2019, annual investment levels should be lower by €1 billion in comparison to the target parameters contained in inputs made for the five-year Strategic Capital Framework (€8.9–9.1 billion instead of €9.8–10.25 billion respectively).
   - (v) There has been a significant increase in the number of transactions agreed on and approved by the Bank, but cancelled by clients at the last minute (€1.3 billion in 2016). Prepayments have also increased (€2.1 billion in 2016); they are eroding the Bank's revenue base and calling into question the sustainability of the Bank's business model.

2. **Decline of the Bank's operational effectiveness.** One of the objective indicators of the EBRD management's performance is the operational cost-to-income ratio. Based on 2016 performance, it amounted to 42 per cent and has already significantly exceeded its planned five-year target (33 per cent). The indicator is also expected to deteriorate further, both in annual terms and as a five-year average. If income from the Russian part of the portfolio is excluded from calculations, this indicator will rise significantly. The EBRD's administrative costs (based on financial reporting data) have already risen by 73 per cent since 2011 (from €270 million to €467 million).
3. **Erosion of the Bank's operational mandate.** Historically, the Bank's work has been based on respect for three of its mandated requirements: (1) transition impact; (2) additionality; and (3) sound banking practices.
   (i) In 2016, 32 per cent of the 56 major signings were either completely or largely related to restructuring or refinancing of existing clients' market debt or to retroactive financing. Of the 149 individual projects approved by the Board of Directors, 28 per cent included refinancing of clients' liabilities to private banks or restructuring of existing debt. This suggests that in many ways, the Bank is crowding out rather than being additional to the private sector. To preserve its compliance with the key principles of the Bank's work, in April 2016, a new definition of EBRD additionality came into effect for refinancing/restructuring projects.
   (ii) The Bank's equity investment is progressively shifting to the right-hand side of the value chain: it is increasingly involved in funding IPOs, rather than preparing IPOs, as before. The financing of leveraged buyouts in advanced countries of operations has become common, with EBRD resources not being channelled wholly towards the development of companies, but rather towards former private owners in countries where the Bank does not operate.
   (iii) The implementation of a system of measuring the Bank's transition impact has actually led to this parameter losing much of its value.
   (iv) According to assessments from the management, Russia is currently the only country in which the Bank prices its transactions at RAROC before EBRD portfolio costs (10.5 per cent) and where the macroeconomic situation tends to improve (in 2017 GDP is expected to rise by 2 per cent, with inflation set to fall to the target level of 4 per cent). Without the Russian market the profitability of the Bank's operations will move further and further away from sound banking practices.

4. **Questionable risk management policies**
   (i) The Bank fails to classify the restructuring operations referred to in Paragraph 3(i) as non-performing assets; this disguises the genuine

issues about their quality. Given the EBRD's privileged status and the fact that it is not subject to oversight by a regulator, the Bank has a relatively lenient attitude to the classification of such operations and to making provision for such loans. Some of the approaches that the EBRD has taken, which in our view, could be classified as regulatory arbitrage, would be inadmissible if the Bank were to be subject to prudential oversight of any kind.

(ii) Contrary to its usual practice, the Bank has not followed the example of the international rating agencies (Moody's downgraded Turkey's sovereign rating in September 2016), and only downgraded the internal sovereign rating of its largest country of operations on 11 January 2017.

(iii) As from January 2017, the management decided to completely abandon the system of internal country ratings, which has usually determined the ratings of private clients. For instance, in the case of Russia they were historically 4-5 notches below the sovereign rating. It is clear that this approach significantly worsens the risk/reward ratio of the Bank's new operations.

The deterioration of the situation and the need to resort to questionable management practices is, in large part, related to the adoption of the "political guidance" that fully suspended new investments in the Russian Federation from July 2014. The EBRD's operations in Russia have always been distinguished by their high credit quality and quick turnover, ensuring significant financial performance and allowing operations to be undertaken in riskier countries/regions without detriment to capital or deterioration of the Bank's risk profile. As a result, by the end of the first quarter of 2017 the Russian portfolio shrank to €3.7 billion from €10.4 billion at its peak in the third quarter of 2012. In addition, while the Russian portfolio had fallen to below 10 per cent of the Bank's total portfolio by the end of 2016, it accounted for 29 per cent of the EBRD's annual revenue.

To justify what it has done, the EBRD is attempting to compensate for lost business by delivering projects which do not always comply with the Bank's key mandated requirements.

In the circumstances, having exhausted other ways of resolving the issue and to protect the interests of the Russian Federation as an EBRD shareholder and country of operations, Russia has no option but to take steps to identify a legal solution to the situation.

It is important to emphasise that in addition to seriously damaging the Bank's financial standing, the implementation of the "political guidance" violates a whole series of legal norms, starting with the Agreement Establishing the European Bank for Reconstruction and Development, and in particular:

1. Article 8.3 of the Agreement, relating to the consideration of whether access by a member to Bank resources should be suspended or otherwise modified. Any decision on these matters must fall within the sole jurisdiction of the Board of Governors and may not be delegated to the Board of Directors.
2. Article 11.2(i) – The Board of Directors shall review at least annually the Bank's operations and lending strategy in each recipient country.
3. Article 13(i) – Dealing with the need for the EBRD to apply sound economic and financial banking principles in its activities.
4. Articles 32.2 and 32.3 dealing with the international character of the Bank and with the inadmissibility of all attempts to exert influence over its management in the interests of individual shareholders/groups of shareholders, extending beyond the clearly defined limits of the EBRD's mandate.

In essence, it amounts to discrimination based on nationality, and is inadmissible as part of the activities of a multilateral development institution. This approach gives rise to the risk of future arbitrary treatment of the statute of the Bank and of its members being deprived of their shareholders' rights without reference to, or in contravention of, the EBRD's statutory objectives and principles. In raising this issue, not only do we say that these decisions with respect to Russia were illegitimate; we are also concerned about the future of the Bank itself, since it has resulted in a contraction of its most profitable loan portfolio, a failure to implement the Bank's transition mandate and the deterioration of its bottom line, with serious and far-reaching consequences.

Russia continues to be open to constructive and engaged dialogue in search of legitimate, mutually acceptable ways out of the present situation, and urges the Bank's management and its shareholders to reach decisions which will ensure the sustainable development of the Bank.