The Effectiveness of Risk Appetite and Culture at the EBRD

An Interview with Managing Director David Coleman

The European Bank for Reconstruction and Development is headquartered in London, but its mission lies to the east: Central Asia, the Middle East, and—until its annexation of Crimea led to international opprobrium—Russia.

Founded in the wake of communism's collapse a generation ago to promote infrastructure development and market economies, the EBRD's expertise remains in "constant demand," says David Coleman, managing director for risk management. In this interview with Steve Shaw, RMA's senior regional consultant, Europe and Australia, Coleman discusses the EBRD's structure, its risk appetite, and its commitment to culture and green projects.

SHAW: What is the mission of the EBRD?

COLEMAN: I joined the EBRD over three years ago and quickly realized that everyone here knows the history and the mission of the organization. That story began after the fall of the Berlin Wall, and with it, the realization that achieving economic stability for the former Soviet Union and Eastern Europe would require an enormous effort. A good proportion of that effort would need to be focused on creating a thriving private sector.

The EBRD has been lending on commercial terms and investing in the equity of private companies in that region ever since. Our only additional requirement is that the investment enables improvements in the sustainability of the economy through improved governance, competition, inclusiveness, integration, resilience, or environmental impact.

The success of the bank's business model encouraged our shareholders (65 governments plus two institutions—the European Union and the European Investment Bank) to extend our remit. We now operate in more than 35 countries on three continents, from Morocco to Mongolia and from Estonia to Egypt.

SHAW: How did the EBRD come to have its headquarters in London?

COLEMAN: At the time of the bank's foundation it was the obvious choice, given the access to the City of London financial

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markets and the ability to attract an international professional staff. That decision was enshrined in the agreement establishing the bank by our shareholders.

SHAW: As a development bank, how, if at all, does your due diligence for a project differ from that which a commercial bank might perform?

COLEMAN: While the EBRD is not a regulated bank, our role is to promote good governance and to raise funds from the capital markets that require substantial compliance with regulations. So from a risk management and compliance perspective, our assessment criteria and evaluation approach doesn't differ from that of any other commercial lender or private equity investor.

However, our client segment and range of suitable activities for which we can lend or invest must provide the opportunity to deliver upon our mission. This can often mean that we require additional due diligence, for example, to ensure such things as procurement are undertaken to internationally recognized standards.

SHAW: The EBRD was founded to promote development and market economics in the former Eastern Bloc. Why was the mission expanded to include Egypt, Central Asia, and other regions?

COLEMAN: In 2016 we celebrated 25 years since the EBRD was founded. In that time we have invested more than €117 billion in over 4,700 projects, ranging from microfinance loans in the Kyrgyz Republic to—just a few days ago—a €187 million loan for the modernization of regional airports in Greece, a key plank in the country's reform program.

It was originally expected that the EBRD's mission would have a finite life, but the economic and political stresses of the last 10 years have led to the realization that the skills and experience developed here are constantly in demand. Consequently, our shareholders have received regular requests to expand our operational territory, including following the Arab Spring in 2010 and to Cyprus and Greece in 2014.

SHAW: How do you see possible changes in U.S. trade relationships under President Trump affecting the EBRD, if at all?

COLEMAN: We have taken note of what the new U.S. administration is saying and we are monitoring events very carefully. The U.S. is our largest shareholder, and U.S. policy guidance is very important to us. We believe we are very well prepared for the new challenges with an even stronger contribution to private-sector development.

SHAW: Given that your headquarters is in London and that you operate in European Union (EU) member countries, how might Brexit affect the way you do business? Is the loss of the United Kingdom's contribution to the EU budget likely to have some impact?

COLEMAN: While the EBRD has European as the first word in its name, we are not an institution of the EU and therefore Brexit does not have a direct impact on us. We have not had any signal from any of our shareholders, among which we count the EU member states and the EU itself, that there is a desire to move the bank's headquarters from its home in London.

In terms of economic impact upon our markets and customers, we are watching developments and are prepared should the situation lead to a setback in terms of Eurozone growth and the consequences that could have for many economies in central and southeastern Europe.

SHAW: In the wake of the financial crisis and subsequent financial scandals such as Libor price fixing and big bank fines, regulators are focusing on the importance of culture, conduct, compliance, and ethics. Has the EBRD made a commitment to these values and, if so, how?

COLEMAN: Joining the EBRD in 2014, with the backdrop of those industry episodes, it was very inspiring to find that staff here were still proud to say they worked for a bank. While the organization avoided the issues you mention, the management team here isn't resting on its laurels.

In 2012, the bank began its own review of the culture and, in 2015, I was asked to reinvigorate that effort. Our program focuses upon promoting six corporate behaviors and aligning incentives to support them, so that how we deliver is given equal consideration alongside what we achieve. We are also investing in leadership and managerial development to maintain the tone from the top.

This internal focus is supplemented by our efforts to promote standards in the markets in which we operate. We do this through close cooperation with regulators and lawmakers, by providing our own experience in governance and compliance areas to provide education, and also by marshalling donor monies to assist in technical areas such as drafting legislation.

SHAW: What about risk and risk appetite? What kind of a return is the bank seeing on projects? Is there an EBRD country risk table that helps inform the interest rate on a particular deal? And what is the relationship/balance between the financial return the bank is seeking and the goal of helping economies grow around the world?

COLEMAN: Our risk appetite is shaped by the competing requirements of our business. On the one hand, we have a mission to do financial things that are "additional"—for example, to stimulate longer-term lending, or to increase the market for local-currency loan capital, or to underwrite the first bond, and so on. We also operate in relatively higher-risk territories and are expected to be countercyclical by lending to sound businesses when there is a credit squeeze.

On the other hand, we are not an aid agency. We are required to invest, applying sound banking principles, in a way that keeps both the risk to the recovery of our shareholders' money and the return at levels that do not undermine our reputation, our funding model, and our capital.

We are helped in these matters by having shareholders that are not focused on the short term. We don't have a share price and our performance is measured by trend, not volatility. We are also not a regulated bank, which gives us freedom to undertake some long-term and countercyclical activities.

However, we do need to borrow from the capital markets to fund our balance sheet and this means that we have to follow market regulations and conventions. Most notably, we need a credit rating for our debt issuance. Our aim is to maintain an AAA rating. Given that our loan book has an average equivalent of a BB rating, that does place boundaries upon the leverage we can apply to our capital and the concentration risk we can carry, as well as the selectivity we have to apply to our new investments and the intensive management we have to adopt with our existing ones.

We subject our balance sheet and the three-year business plan to an annual series of stress tests. Most commercial banks are required to maintain adequate capital for a cyclical downturn of approximately a 1:7 probability. But since the EBRD has to be able to not just survive but lend more in such a period—that is the nature of being countercyclical—we apply a higher standard. We apply a "once in a generation" 1:25 approximation to determine if we can still control our own destiny.

Lastly, because we are not regulated, we do not have a lender of last resort. Our asset and liability mismatch is something we have to ensure that we can manage even when our maturing debt funding cannot be replaced because the capital markets are closed. For liquidity purposes we test that in a 1:100 approximation event such as a one-year capital market closure. The EBRD would be self-reliant, allowing time for our shareholders to decide, in such a worldwide depression event, what they wish to do with the EBRD operating model and skills. These high standards help bridge the gap between BB and AAA ratings.

On the question of return, at the portfolio level we are required to earn a return that covers our costs, including expected loss. In addition, we should then produce a return on capital that covers unexpected loss and the modest distributions our shareholders make to supplement donor funds to pay for technical advice, and finally, provide a small degree of capital growth to support our expansion. In aggregate, the absence of both regulatory costs and dividend or share price demands, plus the benefit of funds raised at the AAA level, makes it possible for us to achieve acceptable returns in the higher-risk areas of our business.

SHAW: Do the countries where the EBRD operates present particular challenges in terms of vetting projects for ties to corruption and money laundering? If so, what measures does EBRD take?

COLEMAN: With the role that we have, we cannot be anything other than committed to maintaining the highest standards of integrity in the conduct of our business. We work hard to ensure that our behavior and the manner in which we choose our project sponsors, clients, co-financiers, and counterparties meet these standards. The bank has developed integrity due-diligence procedures and guidelines which reflect its long experience and

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practice in addressing integrity issues in its countries of operations. These guidelines and procedures help the bank assess potential risk associated with a particular client or sponsor while providing clear guidance as to what is unacceptable.

SHAW: The EBRD recently indicated that it will finance projects in Uzbekistan, which has a new leader, after retreating from that country over human rights concerns. How important are such concerns in deciding where the EBRD will do business?

COLEMAN: Like other organizations and governments dealing with such situations, we have to constantly balance the incentives of engagement in exchange for progress versus the absence of dialogue that disengagement brings. In some cases, we are required to look to the longer term. We never left Uzbekistan, but in the face of circumstances which made our investments virtually impossible, we responded accordingly. We look forward to a new era of cooperation with Uzbekistan and the pursuit of mutually beneficial goals.

SHAW: The EBRD suspended its involvement in new Russian projects following the annexation of Crimea. What would it take for the EBRD to begin lending to Russia again?

COLEMAN: Following guidance given to management in July 2014 by a majority of our shareholders, we have been unable to approve new investment projects in Russia. Any change to this approach would require our shareholders to reconsider.

SHAW: Russia was the largest recipient of EBRD investment. How did losing this partner affect the bank, and have other countries benefited from funds that have been freed up?

COLEMAN: That is correct. At that time, Russia was still the largest country of operations for us, totaling 19% of the EBRD's new investments in the first half of 2014. However, we were able to respond swiftly and comprehensively by increasing our activities in other countries. As a result, we had record levels of investment in both 2015 and 2016, with close to €9.5 billion in new transactions each year. Our largest country of investment in recent years has been Turkey, but with particularly strong performances in Kazakhstan, Poland, and Egypt.

SHAW: Through its Sustainable Energy Initiative, EBRD has financed and has committed to financing various clean and green projects. Can you explain what kind of projects you finance through this initiative and give some examples? Do you have certain goals regarding the amount of money you would like to invest in these efforts, or how many countries you would like to benefit by financing green projects?

COLEMAN: The EBRD has always operated with a strong set of standards for the environmental and social impact that our investments have to meet. This includes sustainable energy activities. As these issues have risen up the international agenda, our experience and skills have been in high demand. Our Sustainable Energy Initiative has basically two streams: investments in energy and resource efficiency and investments in renewable sources of energy like solar, wind, and geothermal. Currently, one-third of our annual investments are made in such schemes and our goal is to increase this to 40% by 2020.

SHAW: The U.S. is the largest shareholder in the EBRD. Can you tell us a bit more about the ownership and management structure? For example, does the U.S. have the most seats on the board? How autonomous is the management of the bank?

COLEMAN: While the U.S. is the single-largest shareholder of the EBRD with a stake of 10.10%, every one of the bank's 67 shareholders is represented on our board. The shareholders with the largest stakes, such as the G7 nations, have dedicated board representatives, whilst the shareholders with smaller stakes agree to be represented through a shared board member. We have 26 board members in total.

The board of directors exercises governance over management by reviewing and approving management recommendations on things such as strategy, policies, the approval of investments that exceed the scope of delegated authority, the business plan, and budget, plus the staff remuneration proposals. And of course, they review both our financial performance and the assessment of progress with the bank's mission. Ⓡ