Speech by Mr. **Nikolay Kosov**
Chairman of the Board, International Investment Bank
Opening Session, “IFRS-9 for Multilateral Development Banks” conference
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Dear Ladies and Gentlemen,

It is a great pleasure to welcome you in Moscow, at the premises of International Investment Bank. Over the last five years of intensive reforms, our primary target and therefore our greatest success was the re-integration of IIB in the financial community and achieving the status of a fully-fledged MDB.

This wouldn’t have been possible without a permanent focus on international best-practices in terms of financial and risk management. The key element of our success so far has been our cooperation with peer IFIs and our openness to dialogue and knowledge sharing.

In this regard, we are looking forward with great enthusiasm to the upcoming two days of discussions and, on behalf of the IIB Board, I would like to thank everyone for accepting the invitation to meet here. I want to address a special thanks to Mrs. Sue Lloyd and International Accounting Standards Board for joining us and sharing the point of view of the most competent institution about the implementation of the new standard. As always, regulators can provide information on the causes that lie behind changing the approach to the classification of financial instruments and risk assessment and also the expected benefits. For us, as users, understanding the causes and expected results is essential in order <u>to transform the challenges into opportunities</u>.

We are honored that prestigious teams from leading global institutions have joined our enthusiasm and are present here to meet you. I envisage Standard and Poor’s that will introduce the perspective of rating agencies. And their role, in my view, is crucial in adjusting possible market failures that can arise in the first stages of implementation. Also the Finastra team, the third largest Fintech company in the world, will discuss the burning issues with you, but most important will introduce solutions to IFRS 9 implementation issues.

The Ernst & Young team will present the view point of external auditors, but at the same time, will act as independent financial experts during the panel discussions. I hope there will be interesting and fruitful debate.

The idea that urged us to organize this informal meeting was to share MDBs’ experience on this *hot* topic in the financial world and to promote best practices and identify acceptable solutions and remedies. In doing so, we are aware that multilateral institutions **are atypical as compared to regular commercial banks**. What are the specificities that in our view are crucial in the context of IFRS 9 adoption?

<u>First of all</u> – our shareholders are sovereigns and their contributions are made in the form of paid-in, as well as callable capital. **Callable capital is a form of financial support** typical for IFIs and, actually, is a blank check issued by shareholders for MDBs to guarantee the financial stability and overall sustainability of IFIs’ activities in the context of deploying their mission. Mostly ignored, never called in by MDBs, the role of callable capital is of growing importance in our view in the current paradigm – strong budgetary constraints of sovereigns versus increasing pressures on MDBs capital.

The Strategy of any MDB is aimed at leveraging the paid-in contributions of its shareholders by raising debt on capital markets. The access to borrowings depends directly on the credit rating and investors’ perception of a certain institution.

This brings me to <u>the second peculiarity of MDBs</u> – namely the absence of a formal regulator, but in practice **the existence of a multitude of regulators**. We have to find a balance between the **requirements of shareholders** and the **expectations of investors**. **These expectations are set in stone by rating agencies** who have significant influence on international debt markets. As a result, to retain their ratings, **MDBs are restricting their overall capacity to make use of their balance sheet to address development needs and limiting counter-cyclical lending**, especially in countries facing economic difficulties. **Such behavior contradicts the purpose and mandate of development banks and consequently reduces their value in the eyes of their shareholders**. This presents a paradox; if development banks become financially conservative, they start to become insignificant for their shareholders and as a result, the shareholders withdraw and weaken their support. But it is this very support, through callable capital and other unique mechanisms, that is the greatest protection for investors. A greater weight should be applied to such shareholder support and should include all shareholders and not only those with AAA ratings. After all, **it is often within the countries with lower ratings where development institutions are of systemic importance** and thus their support should be regarded more highly, rather than as is the often case under the current system, disregarded. Rating agencies and MDBs can and should work closer together in order to fully align methodologies with the development demands placed upon MDBs.

Third and last characteristic of MDB that I want to underline is our mission. We should act complementary to commercial institutions, ensure access to finance for economic sectors that face difficulties in normal access, we are not targeting profit, but development goals. Thus, **MDBs should act counter-cyclically**, whereas commercial banks act mostly pro-cyclical. There are alternative views on how IFRS 9 will affect the behavior of financial institutions, nevertheless, we assume that there is a general understanding that IFRS9 will increase pro-cyclicality.

Now, I come back to what I have mentioned earlier. **Turning challenges into opportunities** in the context of the large-scale transformational change for financial institutions following the IFRS 9 implementation.

The Challenges are obvious, all bankers are talking about them, and all are working hard in order to be ready for January 1st, 2018. Actually, we should be ready on December 31st, 2017 as the first disclosures on IFRS9 impact will be reflected in our year-end financial statements:

- **New classification & measurement requirements** – from our experience we avoided to focus strictly on impairment assessment. C&M is equally important as this is the main drive for the exposures subject to impairment. It actually should be the starting point for a well-balanced IFRS9 methodology;
- **Additional burden on capital**, due to the new forward looking approach on impairment assessment – expected credit loss;
- **Pressures on pricing**, especially on loans – immediate negative impact on the profit&loss statement will definitively affect banks' rules on pricing;
- The **need to develop and enhance business processes, decision making systems and IT solutions** in order to effectively manage the operational processes and financial reporting;
- New **pressures on the risk appetite** - in the face of additional pressure on capital and strengthening the requirements for IFRS9 provisions, MDBs will face the need to search a trade-off between risks and mission;
- **Incorporation of macroeconomic forecasts in our models** – data sources, reliability, back-testing, validation of models – all assessments will be highly sensitive to peaks and bottoms of economic cycles;
- **Duration of investments** – by definition MDBs are vulnerable to this factor as we target longer maturities.

I am sure over the two days discussions, this list will be extended with many other items. What we want to achieve and I definitely encourage you to do so – is to **focus on opportunities**. **Solutions to help us transform challenges into opportunities**. At IIB we are very good at doing this and we are confident that overlapping between the introduction of new accounting standards – *new rules of the game* with the start of our new strategic cycle is more than a simple coincidence. It is an opportunity to consolidate the operational niche and, generally speaking, an opportunity to reconfirm the role of MDBs in the world financial architecture.

- Acting counter-cyclical will become even more an obligation for MDBs – in this regard, we expect to see **a reinforced mandate in financing vulnerable, but vital economic sectors** in our member states – SMEs, green investments, RD&I (research, development & innovation), venture capital. The Development part of our mission will become even more exponential. We expect shareholders to raise this issue during the coming years. At the same time, as our mission described above is complementary to commercial banks and with high social impact, we also expect **reinforced support from the entire financial community** to the MDB activities in order to allow us to deploy our mission properly to its full potential and avoid forcing MDBs to act as commercial institutes.
- IFRS 9 and new business models will lead to **serious developments in risk management** – more efficient monitoring, increased focus on forecast and anticipation of risk events, and the stronger incorporation of macroeconomic indicators in the risk analysis. The coherent and reasonable application of macroeconomic forecasting and its proper reflection in the IFRS9 model is absolutely vital.

- Sovereigns will face an economic enigma – on one hand they will have to stimulate the increase of MDBs investments in critical sectors of their economies in order to fulfill their mission and development mandate, while on the other hand they face the reality of strong budgetary constraints limiting their appetite for any increase in paid-in capital. A balanced solution in our view, could be to **rethink the role of callable capital**. In essence, it serves as a sovereign guarantee for MDBs borrowings on capital markets. Debt alleviates the budgetary effort and allows the leverage on paid-in capital, consequently fostering investments. **A different approach to quantifying the weight of callable capital in the formula calculating capital adequacy ratios both under Basel rules (as a special case for MDBs) and in the methodologies of rating agencies for MDBs** would increase the possibilities to leverage paid-in capital. In essence, we think that this actually is the main role of callable capital.

We warmly encourage all participants to engage in open discussions and use this opportunity, both to identify the main challenges and to strive for common solutions. Dialogue is already a step forward and always generates useful results.

I wish you all the success and am looking forward with interest to the upcoming discussions.

Thank you!