ECA Review: KfW re-evaluating risk

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State-owned Kreditanstalt fur Weideraufbau (KfW), one of Germany's largest banks, has defined itself over the decades through its unrelenting support of domestic enterprise ? the point of its post-war creation. But with a sluggish year ahead, domestically and internationally, the bank, as well as its export and project finance business, is taking sweeping measures to mitigate against risk.

By any standards, 2000 was a phenomenal year for export and project finance businesses worldwide. During that year, KfW extended Eu11.2 billion in loans, compared to Eu9.3 billion the previous year. But new commitments for the first half of 2001 totaled Eu3.8 billion, down Eu1 billion for the same period last year.

The subdued economic climate this year, whose effect was only just beginning to be felt in results from the first half of 2001, was particularly evident in KfW's financing of industrial plant and equipment financing. At the same time, however, the bank has taken substantial measures to minimize risk.

?We are not a commercial bank so we can take a longer perspective with regard to possible risks; we can to a larger extent live with the fact of adverse circumstances,? says Holger Apel, vice president for export and project finance. ?However, we're about half way through the process of renovating our risk strategy for all of KfW,? he says.

The broader strategy overhaul is motivated primarily by prudence, particularly in the wake of economic slowdown. Says Apel, ?though we didn't suffer much from, say, the Asian crisis, we thought it was sensible to take a closer look at risk mitigation techniques.?

For instance, as part of the bank's broader goal of portfolio steering and risk mitigation, it is also looking to enlarge its syndication business. ?We're currently developing a syndications desk. Though we've coordinated syndications in the past, we're trying to increase the levels of our syndications activity,? says Apel. The bank has even set up a unit dedicated to non-performing loans.

Based on the outcome of the new Basle accords, the bank has been forced to use its capital base as efficiently as possible. Practitioners have developed techniques for capital budgeting and one common method uses the ratio of the return on an investment to some measure of the capital allocated to that investment. Risk-adjusted return on capital (RAROC) assigns capital to business units as part of a process of determining the risk-adjusted rate of return.

The bank is currently implementing a risk evaluation strategy based on the RAROC system. ?You have to trace back defaults, ratings and expected losses, so at the end of the day you have a solid pricing tool,? explains Apel.

The majority KfW's export loans made to emerging markets require political risk insurance (PRI), typically from Hamburg-based export credit agency Hermes Kreditversicherung (Hermes).

Although in recent years Hermes covered loans had been declining as a percentage of total KfW commitments, Hermes cover for developing country loans is likely to become an ever more necessary feature of such transactions. Argues Apel, ?I think we've seen that ECA's are fundamentally indispensable for export and project finance. Some people argued that the days of ECA's were gone. But clearly, in the wake of the Asian crisis, for example, that's not the case. The importance of export credit agencies is growing again, and I think there'll always be a need.?

True, Hermes is a key factor in KfW's strategy. But ultimately use of Hermes cover hinges on market practices, to be assessed on a case by case basis.

Also relevant is the ever more international focus of KfW's business. The driving forces are not as uniquely German as they were in the past given that, as Apel points out, deliveries are coming from all over the world. Moreover, the division of labour from such heavyweights as ABB ? who are ever more willing to source goods and services from wherever they can get the optimal package ? is a trend that, according to Apel, ?should be followed by banks like KfW, since we can thereby actually beneficially influence the flow of products.? Last year, over 25% of deliveries were financed from outside Germany.

Above all, the emphasis is on fostering a larger ?network of banks and financial institutions? that can facilitate swift and efficient deal making ? or, to use the popular catchphrase, ?one stop shopping?. ?Yes,? says Apel, ?we've demonstrated our proficiency as lead arrangers, as frontrunners. But our mandate requires us to encourage other banks to participate.?

Apel cites last year's $320 million San Pedro power deal as indicative of not just getting a deal done smoothly, but bringing disparate entities together, thus fostering mutual understanding between previously unfamiliar parties. That transaction called for cooperation between KfW, Hermes, ECGD, IADB, WestLB, CDC and sponsor Cogentrix. ?This was a very difficult exercise at first, but we learned from it and can use it to ease forward similar deals in the future,? says Apel.

KfW has always taken a long term approach to emerging markets. It has typically provided medium and long term financing where commercial bank funds are unavailable. And KfW can raise funds cheaply in international capital markets while also offering attractive rates to clients.

Risks, particularly in developing countries, are increasing these days. But, says Apel, ?once we say yes to a deal, we try to structure it so that the chances for a successful outcome are given, even in unfavorable circumstances. We're not as exposed to developing country risk as one might imagine ? we've brought Hermes on board the bulk of risky transactions.?

Major forthcoming emerging market deals include the $1.3 billion PowerGrid project in India, in which KfW will provide $150 million. Also on the agenda is a KfW loan to the $1.6 billion Yangcheng thermal power plant development in China.

Public private partnership (PPP) financings, also firmly on KfW's agenda, are likely to take up more of the project finance department's time, particularly with the growing international trend towards PPPs. Says Apel, ?among other things, we're following our partners in German and European airports. There are many good examples of what can be done and we're enthusiastic about PPPs going forward.?