ove Office of Evaluation and Oversight

Approach Paper

A Review of IDB Group´s Non-Sovereign Guaranteed Problem Projects

IDB Inter-American Development Bank
IIC Inter-American Investment Corporation

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I. CONTEXT

1.1 **Managing credit risk is a key function of multilateral development banks (MDBs) that lend directly to the private sector without a sovereign guarantee.** Unlike sovereign guaranteed (SG) operations, for which the worst-case scenario is generally delayed repayment, non-sovereign guaranteed (NSG) operations with private counterparts can bring about losses of both principal and interest. An MDB's debt collection record also has indirect effects. First, repayment serves as a key criterion for rating agencies, thus potentially affecting future funding costs. Organizations like the Development Bank of Latin America (CAF), whose shareholders are not AAA rated, have been building up rating improvements on the basis of stellar repayment records. Second, an institution's record of enforcing contractual obligations has reputational effects and sends a key message to existing and potential private sector counterparts. Finally, co-financiers such as B-lenders rely on the lead arranger's reputation to structure sound operations.

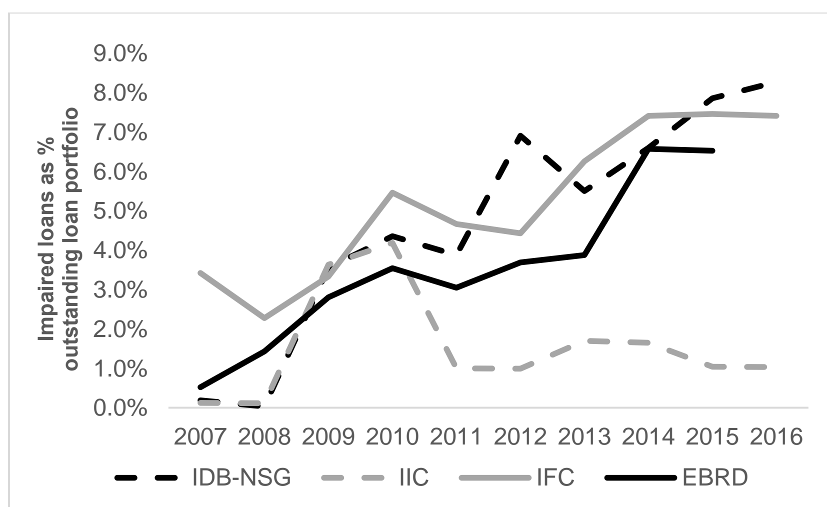
1.2 **The Inter-American Bank (IDB) Group's historical NSG[1] write-offs have been relatively low at 0.2% and in line with comparator organizations: 0.3% at the International Finance Corporation (IFC) and 0.2% at the European Bank for Reconstruction and Development (EBRD).**[2] In part because impaired loans tend to be kept on the books for an extended period until they are finally resolved or written off, the level of impairment in IDB's and comparators' NSG operations shows an upward trend.[3] In contrast, the Inter-American Investment Corporation's (IIC) share of impaired loans rose during the financial crisis but fell again in 2011 and has remained flat since then, likely due both to recovery efforts and to the decreasing risk in its portfolio (with a high concentration of financial intermediary operations).

[1] IDBG's NSG 2016 portfolio includes the NSG operations booked in IIC and in IDB via cross-booking.

[2] Average NSG write-offs from 2007 to 2016 (until 2015 for EBRD, fiscal year ending in June for IFC).

[3] Figure 1.1 measures the stock of impaired loans as a share of the total stock of outstanding loans. If impaired loans are kept on the organization's books rather than being written off or resolved, this ratio will rise as non-impaired loans are paid off and exit the portfolio.

Figure 1.1. Evolution of NSG impaired loans: IDBG and comparators



Source: IDB, IIC, IFC and EBRD Financial Statements

1.3 **IDBG has approached NSG problem projects with a focus on minimizing losses on a project by project basis.** Both the IDB windows dealing with NSG projects and IIC – and now the new IIC, where the NSG operations of IDBG have been consolidated – had project monitoring criteria seeking to identify problem projects. In general, this consisted of flagging projects for increasing degrees of attention (e.g. radar or watchlist) as they presented signs of problems, and ensuring the collaboration of their respective “Special Assets Units” (SAUs), either as advisors or as “recipients” of projects requiring their specialized mitigation and recovery activities. Although loss prevention was a clear objective, as development institutions both IDB and IIC also tried to the extent possible to preserve the viability of projects. The SAUs at both IDB and IIC have involved their Boards in key decisions during the negotiation processes related to impaired assets.

II. EVALUATION DESIGN

2.1 **As part of OVE’s 2017 work program, the Board asked OVE to review IDBG’s recent history of impaired projects, with an eye toward identifying lessons from past experience.** These include the experiences and processes of the former Structured and Corporate Finance Department (SCF) and the Opportunities for the Majority Initiative (OMJ) in IDB and processes in the old IIC, as well as the ones now being adopted by the new IIC.

2.2 **The objective of the evaluation is to shed light on factors that might have affected the extent of NSG losses in IDB and IIC in the past, with an eye to gathering lessons that might be useful going forward.** The evaluation is intended to be forward-looking, as past problems can be viewed as opportunities for future learning, recognizing that development work is inherently risky and some risks will inevitably materialize. The evaluation will (i) analyze the reasons leading projects to become impaired to see if any patterns emerge; (ii) review organizational structures and processes in the IDBG, both past and present, to see how these have functioned over time; and (iii) look at practices at selected multilateral and institutions and private financial institutions to see if lessons emerge. Among multilaterals, IFC and EBRD have a strong reputation for

handling problem projects, including those caused by systemic country crises such as the one involving Russia at EBRD. Among private sector comparators, commercial banks can gather lessons on SME collection issues and investment banks on collection issues related to more complex, larger projects. OVE will not conduct a comprehensive review of external practices but rather will seek to gather potentially applicable lessons from these few comparator organizations.

2.3 **OVE's review will focus on 66 IDBG NSG projects[4] that were financially impaired[5] at some point over the last 10 years**. The review's common denominator will be projects deemed by IDBG management as posing a risk of financial loss, also called "impaired", "doubtful", "written-off" or "loss" projects. Most of the 66 impaired projects were small (usually with SME clients of the old IIC and OMJ), while a few large projects (mainly in infrastructure of the old SCF) accounted for most of the volume. Some of these projects later recovered full value, while others spiraled downwards. The 10 year period will allow enough time for projects to have been resolved and for varied economic conditions to occur.

2.4 **The evaluation will address the following questions:**

- **What were the main causes of problems in NSG projects?**
  - What were the characteristics of projects that defaulted?
  - Are there common reasons why they went into default?
  - To what extent were the risks in these projects identified at approval and, if identified, justified in the loan proposal by a strong development rationale?
- **What project traits and/or IDBG processes appear to be associated with more positive post-default outcomes?**
  - Were any particular project traits associated with relatively positive post-default results?
  - Is it possible to identify post-default procedures that appear to have helped the IDBG achieve relatively positive post-default results?
- **Do the experiences of comparator financial institutions offer any lessons for IDBG on how to handle project projects?**

2.5 **To address these questions OVE will conduct** (i) a desk review of IDBG Impairment Reports (and other relevant documentation if needed) for the 66 problem projects in the evaluation portfolio, (ii) a document review and structured interviews with current and former IDB and IIC staff regarding the policies, practices, and organizational setups to deal with problem projects at IDBG; and (iii) structured interviews with relevant staff of selected comparator organizations, most likely including IFC, EBRD, and at least two private sector banks.

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[4] Apart from these 66 projects, 24 other impaired projects were excluded from the review. Seven were approved before 1996 (though still under SAU during the 2007-2016 period) and were considered too old to yield useful lessons on current practices. Fifteen were equity projects and two were guarantees that were excluded due to equity's and guarantees' different natures.

[5] This includes projects that were written-off during the period, regardless of whether they had been declared financially impaired before. However, it excludes "rounding down" write-offs of less than $1,000, usually resulting from minor adjustments, such as fees waivers in otherwise financially sound projects.

2.6 **The evaluation team includes Alejandro Soriano and Roland Michelitsch (team leaders), Roni Szwedzki, Patricia Oliveira, and Melanie Putic.** To facilitate management review in light of the busy year-end bunching season, a draft of the evaluation is expected to be delivered to management in December 2017, and the final evaluation is expected to be delivered to the IIC Board of Executive Directors in January 2018.