



Mid-term Evaluation of
IDB-9 Commitments

Financial and Risk Management

Background Paper



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Office of Evaluation and Oversight

1350 New York Avenue, N.W.

Washington, D.C. 20577

www.iadb.org/evaluation

ABSTRACT

This paper analyzes whether the Inter-American Development Bank (IDB, or Bank) has fully and effectively implemented the IDB-9 requirements related to risk and financial management. IDB-9 included four requirements in this area: (i) adopt a rule-based Income Management Model (IMM); (ii) implement the recently introduced risk-based Capital Adequacy Policy; (iii) execute a set of agreed actions to enhance the short-term sustainability of the Fund for Special Operations (FSO); and (iv) continue strengthening the Bank's Risk Management Framework.

The Bank has fully implemented the IDB-9 financial and risk management actions. The highly detailed and prescriptive nature of the requirements aided implementation. In terms of effectiveness, the IMM imposes financial discipline and enhances financial self-sustainability by linking Bank expenses directly to income through loan charges. The CAP supports prudent risk management and the Bank's AAA rating. The actions taken for the FSO will not be sufficient to ensure the Fund's sustainability until 2020, as mandated in IDB-9, and Management is preparing to propose additional measures for the Board's approval.

A few issues with the IMM and CAP merit further review going forward. First, the IMM is very strict, with a high administrative expense coverage rule and its inclusion of nonoperational expenses. Second, it is not clear that the reserve ratios for sovereign-guaranteed (SG) and non-sovereign-guaranteed (NSG) exposure adequately reflect their relative levels of risk or lead to the most effective leveraging of scarce Bank capital. Third, the Bank's unused borrowing capacity rule—though perhaps reassuring to potential investors—is outdated and is not relevant to the maintenance of the Bank's AAA rating, while a criterion that rating agencies do consider relevant—country portfolio concentration—is not factored into the Bank's rules. Finally, the IDB-9 architecture is inward-looking and does not promote a focus on the Bank's financial competitiveness.

In light of these findings, OVE suggests that the Bank (i) consider introducing greater flexibility in the IMM by setting an administrative coverage band and perhaps excluding certain nonoperational expenses; (ii) review the capital accumulation rule and the reserve ratios for SG and NSG exposures; (iii) update the Bank's financial rules by phasing out the borrowing authority limit; and (iv) use the financial and risk management architecture as input to strategic decision-making on the projected size of the Bank, the blend of SG and NSG lending, expected countercyclical support, the role of the FSO, and the Bank's approach to future capitalization.

PREFACE

The Inter-American Development Bank (IDB) is in a period of rapid change, responding to both the economic dynamism of the Region it serves and the increasing competition in the international financial marketplace. Over the past decade, countries in Latin America and the Caribbean have gained greater access to alternative sources of finance and an increasing ability to generate and share knowledge among themselves. Like other multilateral development banks, IDB is seeking to adapt to this changing international landscape by ensuring that it is responsive to borrowing countries' needs and putting strong emphasis on effectiveness in its use of scarce resources.

In 2010 the IDB's Board of Governors approved the 9th General Capital Increase of the IDB (IDB-9). The IDB-9 Agreement laid out a series of reforms intended to strengthen the strategic focus, development effectiveness, and efficiency of the IDB to help it remain competitive and relevant in the years ahead. As part of that Report, IDB's Office of Evaluation and Oversight (OVE) was charged with conducting a midterm evaluation—to be presented to the Board of Governors in March 2013—to assess IDB's progress in implementing those reforms. The full evaluation is available at www.iadb.org/evaluation.

This paper is one of 22 background papers prepared by OVE as input to the IDB-9 evaluation. It seeks to determine whether one portion of the IDB-9 requirements has been implemented fully and effectively and to offer suggestions to strengthen implementation going forward. The overarching goal of this paper and the entire evaluation is to provide insights to the Governors, the Board, and IDB Management to help make IDB as strong and effective as possible in promoting economic growth and poverty reduction in Latin America and the Caribbean.

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This background paper was prepared by Alejandro Soriano, Alexis Smith-Juvelis, and Tatiana Soares, under the direction of Cheryl Gray. All background papers were thoroughly reviewed and discussed within OVE and shared with IDB Management for comments. The other background papers and full IDB-9 evaluation can be found at www.iadb.org/evaluation.

ACRONYMS AND ABBREVIATIONS

ACR	Administrative coverage ratio
ADB	Asian Development Bank
AfDB	African Development Bank
ALCO	Asset and Liability Committee
bp	Basis points
CAF	Andean Development Corporation
CAP	Capital Adequacy Model
CRCS	Credit Risk Classification System
CUR	Capital utilization ratio
FSO	Fund for Special Operations
GCI	General Capital Increase
IBRD	International Bank for Reconstruction and Development (World Bank)
ICAPA	Integrated Capital Adequacy Policy and Portfolio Analytics system
IDB	Inter-American Development Bank
IDB-9	Ninth General Capital Increase of the IDB
IFC	International Finance Corporation
IMM	Income Management Model
LAC	Latin America and the Caribbean
LTFP	Long-term financial plan
MDB	Multilateral development bank
NSG	Non-sovereign guarantee
OC	Ordinary capital
OVE	Office of Evaluation and Oversight
PCT	Preferred creditor treatment
RAC	Risk-adjusted capital
S&P	Standard and Poor's
SG	Sovereign guarantee
UBC	Unused borrowing capacity

EXECUTIVE SUMMARY

During the months leading to the Ninth General Capital Increase (IDB-9), the Inter-American Development Bank (IDB, or Bank) introduced new risk and financial management tools to address the effects of the global financial crisis. When Governors met in Cancun in March 2010, they placed a premium on conservative tools for financial management of the Bank. Governors further sought to make these tools permanent by including them expressly in the IDB-9 Agreement. This fit with the Governors' overall endorsement of the Agenda for a Better Bank, seeking an IDB that was not only larger, but also better. Being able to more transparently link financial decisions with results was key to that agenda.

IDB-9 adopted four key initiatives in the area of risk and financial management. Two novel, rule-based restrictions addressed both the flow and the stock of the Bank's ordinary capital: the Income Management Model (IMM) and the Capital Adequacy Policy (CAP). Governors also agreed to provide temporary relief for the Fund for Special Operations (FSO), in preparation for potential replenishment talks by 2020. Finally, they required Management to continue its efforts to strengthen the Bank's Risk Management Framework. All commitments were abundantly detailed by Management, and mandated in full by the Governors.

Implementation completeness

The Bank has fully implemented the IDB-9 financial and risk management actions, needing only minor adjustments going forward. Full implementation has been facilitated by the highly detailed and prescriptive nature of the requirements in this area, with models being exhaustively described as part of the IDB-9 Agreement.

The IMM is a rule-based approach that links ordinary capital's revenue sources and uses in a long-term planning horizon. It marks a departure from IDB's prior loan pricing practice by requiring that loan charges cover 90% of administrative expenses. This approach and requirement is unique among multilateral development banks (MDBs).

The new CAP aims at ensuring that sufficient capital is available to sustain the Bank's risk-bearing activities, and most prominently its lending. The CAP's risk-by-risk approach is more comprehensive than the capital provisions under the Bank's prior policy. Thus it is better suited to tracking the expected expansion in non-sovereign-guaranteed (NSG) lending, which involves undertaking the risks of lending to numerous private sector clients. The Bank has fully implemented the CAP, though a few issues could usefully be reexamined, in particular the relative capital reserve ratios for sovereign-guaranteed (SG) and NSG exposures.

At the time of the IDB-9, the financial situation of the FSO was already severely strained. In anticipation of a replenishment by 2020, IDB-9 provided only short-term actions, which the Bank has fully implemented. Although not agreed at IDB-9, the FSO needs a strategic redefinition, including exploring options for its revitalization.

Implementation effectiveness

Although IDB-9 was not always explicit about the objectives to be achieved by introducing these new financial and risk management actions, Governors considered five key explicit and implicit objectives, with some trade-offs among them: (i) preservation of the Bank's AAA rating; (ii) enhancement of the Bank's financial discipline and self-sustainability; (iii) use of the Bank's capital to support the maximum prudent lending levels; (iv) possible provision of countercyclical lending to Latin America and the Caribbean; and (v) competitive loan pricing. Measuring by the extent to which implementation of the IDB-9 reforms helped meet these objectives, OVE concludes that effectiveness to date has been mixed.

The Bank's stand-alone shareholder equity relative to risk is the most critical component in its overall AAA credit rating. The other details of IDB-9's capital adequacy and pricing models are largely irrelevant to the rating, except insofar as they affect the simple ratios assessed by the rating agencies. IDB-9's historical reliance on callable capital has declined in importance as a rating criterion. The Bank's borrowing authority limit—though perhaps reassuring to potential investors—is outdated and is not relevant to the maintenance of the Bank's AAA rating, while a criterion that rating agencies do consider relevant—country portfolio concentration—is not factored into the Bank's rules. The relatively small amounts of paid-in capital make the Bank's earnings capacity a key driver in maintaining capitalization levels consistent with a AAA rating. The Bank is now adequately capitalized, and, to preserve the AAA rating over the long run, the parameters of CAP and the capital accumulation rule need to be calibrated with the likely evolution of the Bank's portfolio.

Governors implied, but did not clarify, the intended level of financial self-sustainability that the Bank was to achieve with IDB-9. Thus, Management assumed certain CAP and IMM parameters along the way. The IMM parameters are strict—unique among MDBs—requiring that 90% of administrative expenses be covered by loan charges over a long 10-year horizon and including nonoperational expenses in this calculation. These requirements may have unintended consequences, such as raising loan charges more than necessary or moving the Bank to reduce expenses at any cost. In addition, it is not clear that certain nonoperational expenses, especially those related to investment, should be included in the IMM coverage rule.

A clear objective of the IDB-9 capital increase was to increase lending to the Region to a new sustainable level of US\$12 billion a year, the lowest of the demand scenarios discussed in the IDB-9 negotiations. The Bank's self-imposed borrowing authority limit was introduced more than 50 years ago, with a rationale that no longer underpins the external agencies' rating on IDB's debt. By gradually removing the Bank's borrowing limit, with investor and rating agencies' backing, and relying exclusively on the availability of risk-weighted capital (as other MDBs do), it might be possible to increase lending capacity prudently.

IDB-9 expressed a general desire for countercyclical lending capacity, but never agreed on its extent. Up to now, the Bank has relied on opportunistic actions, such as front-loading of lending during crises and the recent introduction of a countercyclical instrument that relies on IDB-9's capital build-up until 2015. But there is a trade-off

between the Bank's countercyclical capacity and its current lending charges, as higher charges would be needed to build capital for a future countercyclical response. Countercyclical capacity is further constrained by the adoption of an inherently procyclical CAP that reacts to downturns by reducing lending exposure. If the IMM and CAP are to build the required reserves, they need a clear articulation by Governors and the Board of the desired countercyclical coverage.

The IMM, and to a lesser degree the CAP, define SG charges via a predominantly inward-looking process. By mandating a fixed administrative expense coverage at all times, the IMM limits the Bank's ability to respond to competitive pressures. IDB will likely remain competitive in the short term because of its lower funding costs, but the fact that the Bank's financial architecture lacks a clear market orientation merits further consideration to avoid erosion of IDB's financial competitive advantage over time.

Suggestions going forward

In light of these findings, OVE has four suggestions for the Bank's consideration:

1. **Introduce greater flexibility and market-responsiveness in IMM.** Greater flexibility could be introduced into the model by setting an administrative expense coverage band, which would allow the Bank to operate within a range of coverage ratios, and by reviewing what expenses are included in the coverage rule. This would give the Bank some flexibility to price more competitively or meet urgent spending needs if needed, while still on average maintaining the discipline mandated by the Governors.
2. **Refine the Bank's capital management.** The IMM's capital accumulation rule could be strengthened by adding stability in the capital planning process through the introduction of an operational band based on a long-term view of the Bank's portfolio composition. Additionally, OVE recommends that the Bank review its capital reserve ratios for its SG and NSG lending portfolio.
3. **Update rules by phasing out the borrowing authority limit.** The current borrowing authority limit dates back to the Bank's first debt issuance, more than 50 years ago, and was not part of the IDB-9 discussions. This limit not only has the potential to constrain the Bank's lending, but also focuses on the Bank's callable capital—an item of decreasing importance to external credit rating agencies. Thus, OVE suggests that the Bank gradually remove the existing limit and replace it with a leverage limitation more aligned with current market perspectives as defined by external credit rating agencies, and in line with what comparable development institutions do.
4. **Enhance the usefulness of IDB-9's financial and risk management models in decision-making.** OVE suggests that IDB-9 models be further leveraged by enhancing their usefulness as decision-making tools. They could be used to highlight trade-offs more clearly, such as the trade-off between countercyclical lending capacity and price competitiveness, and to help to assess the long-term financial and risk implications of strategic business decisions.

I. INTRODUCTION

- 1.1 Over the year leading to the Ninth General Capital Increase (IDB-9), the Inter-American Development Bank (IDB, or Bank) introduced new risk and financial management tools to address the consequences of the global financial crisis. When the Governors met in Cancun to agree on IDB-9, the Bank had recently experienced unexpected nominal losses in its investment portfolio,¹ and its financial capacity was strained because it had temporarily doubled its lending support.² Yet there was a growing feeling among shareholders that the Bank needed to become not only larger, but better, and in part this would require more transparently linking financial decisions with results. Some shareholders were concerned at the crowding out of the Bank's non-sovereign-guaranteed (NSG) business during the crisis, while others sought to solidify an adequate countercyclical response capacity. Finally, there was a demand to guarantee nonreimbursable, long-term support to Haiti.³
- 1.2 A premium was placed on conservative tools to financially shield the Bank, and the Governors adopted them as part of the IDB-9 Agreement. The Governors endorsed the significant reforms of the Bank's financial and risk management architecture that Management had recently introduced: two novel, rule-based restrictions, addressing both the flow and the stock of the Bank's ordinary capital (OC), the Income Management Model (IMM) and the Capital Adequacy Policy (CAP). The Governors further agreed to leave the Fund for Special Operations (FSO) structurally unchanged, providing only temporary relief, mostly through the mandatory reassignment to OC of the rising demand for support to Haiti.⁴ Finally, the Governors required that Management continue its efforts, spearheaded by the Board, to strengthen the Bank's Risk Management Framework, focusing on developing tools and capabilities that meet international best practice standards.⁵
- 1.3 As part of the IDB-9 Agreement, the Governors mandated that the Office of Evaluation and Oversight (OVE) assess the full and effective implementation of these reforms. In line with this requirement, this background paper reflects OVE's

¹ In 2008, the Bank's trading investment portfolio experienced net mark-to-market losses of US\$1,605 million, which were mostly recovered in subsequent years.

² The increase in lending was a response to G20 demands. By the time the Cancun Declaration was issued (March 2010), the Bank had raised its annual approval rate to around US\$12 billion, up from a pre-crisis average of about US\$6 billion.

³ On January 12, 2010—only weeks before IDB-9—a catastrophic magnitude 7.0 Mw earthquake struck Haiti, with its epicenter 25 km. west of Port-au-Prince, Haiti's capital and main population center. By the time of IDB-9, intense recovery efforts were still under way, and the toll of the humanitarian and economic catastrophe on Haiti—IDB's least developed member country—had yet to be fully assessed.

⁴ Additionally, the FSO administrative charge was reduced to 3% and technical cooperation expenses were transferred to the OC.

⁵ Cancun Declaration, AB-2728, March 2010

independent assessment of the four IDB-9 mandates in the risk and financial management area: IMM, CAP, FSO, and the Risk Management Framework. The assessment aims at verifying (i) *how complete* the implementation has been in complying with the detailed directions in the Cancun Declaration and IDB-9 Report; and (ii) *how effective* this implementation has been—or is expected to be—in achieving the underlying objectives the Governors were pursuing in mandating these reforms.

II. IMPLEMENTATION ASSESSMENT

- 2.1 In the Cancun Declaration, Governors mandated that the Bank “implement an income management model that [incorporates] the new capital adequacy policy, lending program, loan charges, technical assistance grants, and commitments on transfers in a way that [sets] the Bank on a firm financial footing, preserve[s] its AAA rating, rationalize[s] the allocation of resources through a comprehensive and simultaneous approach, and allow[s] capital to grow over time through the retention of income.” Governors also endorsed a blueprint of the IMM (as one of the two annexes to the IDB-9 Report); a clear definition of the CAP, which had recently been approved; and detailed provisions for the FSO. The last requirement was more generally stated: “ensuring that risk management practices and capabilities meet international best practice standards.”⁶ This section looks at each of the elements and assesses the completeness of their implementation against the specific and detailed expectations set out in the IDB-9 Report.

A. Income Management Model

- 2.2 The IMM transparently links OC revenue sources and resource commitments in a long-term planning horizon. By its design, the IMM ensures that the Bank generates sufficient income to cover a great majority of operating expenses, as well as such OC net income allocations as knowledge and capacity-building products and the US\$200 million annual transfers to the grant facility for Haiti.⁷ As a result, the IMM constrains annual decisions on sovereign guaranteed (SG) loan charges, under each projected long-term (10-year) scenario of operating expenses and other OC income allocations. According to the Cancun Declaration, “loan charges [are] set as to cover administrative expenses consistent with the Bank’s multiyear budget.” The IDB-9 Report sets this expense coverage at 90%. Corrections are made through a 3% reduction of the expense base to be charged to FSO and income recognition of 90% of NSG proceeds.
- 2.3 This rule-based approach includes various predefined constraints. The IMM introduced an administrative coverage ratio (ACR) under which SG loan charges should be such that loan charge income⁸ covers, at a minimum, 90% of OC

⁶ Cancun Declaration, AB-2728, March 2010.

⁷ The knowledge and capacity-building product charges and Haiti transfers are subject to annual approval by the Board.

⁸ For the purposes of this calculation, interest income is equal to 100% of SG loan charges plus 90% of NSG loan charges.

administrative expenses on a three-year rolling historical weighted average basis.⁹ It should be noted that without this constraint, the Bank's loan and fee income still covered, on average, over 80% of expenses.¹⁰ While the absence of a rule allowed more volatility in the yearly expense coverage, it also provided Management with more flexibility in its financial planning. In addition, the IMM has to satisfy the following conditions: (i) minimum annual transfers of US\$200 million to the grant facility for Haiti; (ii) a capital accumulation rule that preserves the Bank's financial soundness; (iii) the parameters of the CAP;¹¹ and (iv) nonreimbursable technical cooperation fully funded by OC. In practice, the IMM creates a "loan charge floor," which is directly associated with these predefined internal constraints.

- 2.4 The IMM marked a departure from IDB's prior loan pricing practice. Before IDB-9, the Bank did not apply strict quantitative conditions to set loan charges. Instead, for SG loans, it applied a standard loan charge of 45 basis points (bp)—a lending spread of 30bp, credit fee of 25bp, and inspection/supervision fee of 0bp—based on a four-year projection. This charge applied as long as the total equity-to-loans ratio fell between 32% and 38% and was projected to grow in the medium term, and net income projections were positive. If these conditions were not met, additional charges would apply, but their imposition was subject to annual deliberation and approval by the Board of Directors. There was no restrictive methodology to guide those deliberations.
- 2.5 The IMM was also intended to serve as a more comprehensive decision-making tool for the Board of Directors. Since "the OC income process is a closed system whereby changing any one parameter will affect the value of other key parameters..., annual decisions related to uses of OC income will be driven by trade-offs."¹² Management was expected to provide the Board with full and quantifiable information regarding these different scenarios and trade-offs,¹³ detailing the annual allocation of key financial parameters¹⁴ for the following year, so that the Board could make objective financial decisions about the Bank's OC on the basis of long-term financial projections.
- 2.6 OVE finds that the Bank has fully adopted all the formal requirements related to the IMM, as set out in the Cancun Declaration and IDB-9 Report. The Governors

⁹ The ratio of the sum of the OC administrative expense estimated for the following year being planned, the current year, and the previous year, over loan charge revenue for the same period.

¹⁰ See Management's PP-71, Proposal for an Income Management Model for the Ordinary Capital. PowerPoint presentation, May 2010.

¹¹ The IMM uses the CAPs desired bands based on stress tests, to determine an operational band. The operational band is set at the 10th and 90th percentile of the desired bands. The IMM financial projections need to remain inside this band.

¹² IDB-9 Report, Annex 2, para. 2.1.

¹³ Namely, the sources of revenue (loan spread, fee income, and return on "free" funds), and the uses of those revenues (administrative expenses, technical cooperation, and knowledge and capacity-building products, transfers to the Grant Facility, and capital accumulation).

¹⁴ These financial parameters include sustainable lending levels, loan charges, administrative expenses, and transfer commitments.

required that, starting in FY11, Management submit for approval by the Board of Executive Directors a long-term financial planning and programming document (LTFP) proposing allocations for the following year. Management has presented to the Board two OC LTFPs for their determination of loan charges for 2011 and 2012, and the final 2013 LTFP is now complete and has been submitted to the Board of Executive Directions for consideration and approval. These actions fully satisfy the IDB-9 requirements regarding the IMM, in both form and time.

- 2.7 A few remaining implementation issues likely stem from the speed with which the IMM was conceptualized and adopted, without sufficient opportunity for testing, so that it is now producing unanticipated effects. For example, when establishing the parameters of IMM, the Governors mandated that the ACR be applied on the Bank's administrative expenses as reflected in its financial statements. While this provides some certainty by reference to publicly available and auditable figures, it also carries the potential for distortions derived from accounting rules designed for a different purpose. These expenses include, among other things, depreciation of capital projects, and they are affected by extraordinary items, such as the coverage of pension liabilities. Furthermore, while most operational expenses are predictable and easy to project, other obligations—such as actuarial pension expenses—are volatile and, thus, harder for Management to control. The ACR was set without sufficient analysis of the potential effects that these hard-to-project expense lines could have on loan charges.
- 2.8 Similarly, the extent to which volatility in disbursement patterns could affect loan charges had not been fully anticipated. Projecting disbursement patterns is highly uncertain because of the Bank's fairly flexible disbursement rules and changing client conditions. Thus, because actual disbursement patterns may differ significantly from projections, it is difficult to set loan charges that will yield the revenue necessary to satisfy the ACR. This introduces volatility in lending rates and compromises the Bank's planning ability. Management should further test the IMM to identify, among the uncertain items, the ones that can have the strongest impacts on IMM results, and then develop appropriate mitigation strategies, rather than adjust for these effects on an ad hoc basis.¹⁵

B. Capital Adequacy Policy

- 2.9 In Cancun, the Governors explicitly adopted the recently approved CAP, directing Management to “implement the new Capital Adequacy Policy.”¹⁶ The CAP aimed at defining “the amount of capital necessary to maintain the Bank's AAA credit rating while being able to sustain lending during downturns. This mandate is translated into capital requirements for the different kinds of risk the Bank encounters in its operations.”¹⁷ Management was also required to provide

¹⁵ In the 2013 LTFP, unexpected changes in pension expenses resulted in a 17% growth in expenses in 2012, which translates into a 17bp increase on the spread.

¹⁶ Cancun Declaration, para. 3.

¹⁷ IDB-9 Report.

- quarterly reports of the results and relevant risk estimates of the CAP, and to conduct annual reviews of its input parameters and methodologies.
- 2.10 The CAP was also appropriate for tracking the expected expansion of the Bank's NSG exposure. IDB-9 was approved at the time of a desire for significant expansion in the Bank's private sector operations, and the CAP's risk-based approach was tailored after similar models that commercial banks and their independent regulators use to assess solvency, so they can gauge the need for additional capital or disposition of lending assets. This approach is particularly suited for the Bank's NSG business. In fact, the Governors used the CAP to set new NSG limits. Before IDB-9, NSG lending had been capped at 10% of the Bank's outstanding loan balance. IDB-9 provided that "until December 31, 2012, the Bank would cap NSG operations by an amount such that its risk capital requirements would not exceed 20% of total Bank equity. After January 1, 2013, limitations on NSG operations would be subject to review, and potential expansion, by the [Board], as long as they remained compliant with this capital adequacy policy."¹⁸
- 2.11 The CAP is also more comprehensive than the previous policy. Under the CAP, the Bank's available capital—or equity¹⁹—is "utilized" to cover the Bank against its risk-bearing activities, broken down into seven categories.²⁰ In commercial banking (Basel) terms, the Bank's CAP implementation adopts an internal ratings-based approach, for which the Bank itself develops risk assessments.²¹ Risk-based capital requirements are divided by total equity to give a capital utilization ratio (CUR). To ensure that the Bank is always properly capitalized, the CAP stipulates that the CUR must fall within a desired zone, whose width is set through agreed stress tests. This risk-by-risk approach is more comprehensive than the capital provisions under the Bank's prior policy, which were based on only one aggregate total-equity-to-loans ratio.
- 2.12 The introduction of the CAP was partly a reaction to the concerns that the Bank's real risk exposures were not being properly captured by the existing risk management tools. This stemmed from the fact that the Bank's investment portfolio had experienced unexpected net mark-to-market losses of US\$1,605 million in 2008. Moreover, OVE's 2009 "Review of the Bank's Investment Policy," which pointed to these losses, recommended, among other actions, that the Board approve an explicit risk appetite statement, as a way to proactively agree on the level and type of risk the Bank is willing to incur in the performance

¹⁸ IDB-9 Report, para. 3.33.

¹⁹ Defined as paid-in capital, general reserves, special reserves, allowances, and adjustments.

²⁰ These risk-bearing activities are classified as SG credit risk, NSG credit risk, market risk in lending operations, investment credit and market risk, derivatives in counterparty credit risk, operational risk, and risk in the Bank's retirement plans.

²¹ Estimates are based on the Bank's own default history and statistical variables (i.e., time horizon, confidence interval) to determine risk parameters that fit the Bank's business model. Risk parameters for the purposes of CAP include probability of default, losses given default, and exposure at risk. Some of these risk parameters are based on information derived from external sources, such as rating agencies.

of its mandate. This proactive statement was not made a mandate in IDB-9. Instead, CAP represented a more passive way to link existing risks to the capital required to properly bear them, to ensure that sufficient capital was on hand.

- 2.13 OVE finds that the Bank has largely implemented the requirements related to the CAP set out in the Cancun Declaration and IDB-9 Report. Specifically, Management has set up the capital adequacy model and methodology to produce the risk estimates. Management has also reported as expected to the Board of Executive Directors on the Bank's risk and capital requirements, and has provided annual reviews of the main input parameters and methodologies. In addition, CAP has been integrated with the IMM, with its outputs (CUR and CUR desired zones) serving as a direct input in LTFP projections.
- 2.14 While the CAP has been implemented as per IDB-9 requirements, it is important to recognize the limitations of capital adequacy models in the context of multilateral development banks (MDBs). Commercial banks routinely estimate risks based on the statistical behavior of their atomized portfolios. By contrast, the Bank has a concentrated business model, with only 26 sovereign clients and at most a few hundred NSG clients. This hinders the Bank's ability to use past data to infer future risk patterns, and thus calls into questions the accuracy—and suitability—of any model that relies on these estimates.
- 2.15 In fact, the CAP may be underestimating NSG credit exposures, overestimating SG credit exposures, or both. The Bank uses different conceptual models to assess NSG and SG credit risk.
- NSG risk estimates are based on a “solvency model” that assumes the possibility of unrecoverable losses. Normalized risk estimates are assigned to each individual NSG operation through a Bank-developed internal Credit Risk Classification System (CRCS). These estimates are adjusted to the Probabilities of Default published by Standard and Poor's (S&P), which are based on U.S. corporate default history. Given the differences between U.S. and Latin America and Caribbean (LAC) markets, it is likely that the Bank has not been allocating enough economic capital to account for NSG risk exposure. Despite this limitation, the Bank has made efforts to verify its Probabilities of Default and Losses Given Default through the Global Emerging Markets Database consortium.
 - SG risk estimates are based on a “sustainability model” that assumes that SG clients will not default, and the only credit risk is posed by payment delays. SG capital requirements are based on a “sustainability test” to ensure that, in the event of a nonaccrual,²² the Bank has enough capital to avoid negative net income over 10 years.²³ This test is based on a harsh assumption that a

²² The CAP determines that a portion of the portfolio goes into nonaccrual based on a statistical modeling process that takes into account the SG lending portfolio's ratings, probabilities of default, and preferred credit treatment.

²³ Some other MDBs, such as the European Bank for Reconstruction and Development (EBRD) and the African Development Bank (AfDB) use shorter horizons of 3 to 5 years.

country will remain in nonaccrual for an extended time, even though the Bank's longest nonaccrual experience lasted approximately four years. Overly restrictive assumptions that are not based on data may make the IDB less competitive. Additionally, to quantify risk, the Bank currently uses SG Probabilities of Default published by rating agencies—primarily S&P—and adjusts them up three notches to account for IDB's preferred creditor status. This external ratings-based approach may be overly restrictive, and not fully indicative of the SG risk profile of the Bank.²⁴ Some MDBs have made efforts to develop internally derived risk ratings and Probabilities of Default, while others have bilateral agreements with the World Bank under which they have full and cost-effective access to its Probabilities of Default for capital adequacy purposes.

- 2.16 After applying these fundamentally different risk models and assumptions, IDB's capital requirements for SG exposures are slightly higher than for NSG exposures.²⁵ As Table 1 shows, this differs from other MDBs, which require up to twice as much capital for NSG exposures as for SG exposures.

Table 1. Capital Reserve Ratios by Asset Class

Asset classes for banking risk	IDB	IFC	EBRD	AFDB	IBRD
Sovereign loans	27%	N.A.	10%	29%	23%
Private sector loans	23%	22%	20%	42%	N.A.
Guarantees/TFP	N.A.	11%	20%	N.A.	N.A.
Equity	N.A.	70%	60%	N.A.	N.A.

Source: Internal capital adequacy documents provided by multilateral institutions.

Note: IDB data based on year-end 2011.

- 2.17 Additionally, the CAP uses assumptions that are not fully consistent with the IMM. This issue is most critical with the CAP's exposure projections. According to Management, the CAP assumes a zero portfolio growth for SG and NSG. While this may simplify the calculation of net interest income as well as appropriate capital to undisbursed balances, it also results in an overestimation of new disbursements, when compared with IMM assumptions,²⁶ which may lead to an overestimation of capital requirements. The CAP should be based on the assumptions of approvals and disbursement profiles from IMM, as they represent more realistic estimations of the changes in the portfolio composition, and thus allow a more accurate estimation of capital requirements.

²⁴ The IBRD Probabilities of Default rates are significantly lower than those of the rating agencies for sovereign borrowers.

²⁵ An average was taken based on capital requirements relative to equity on all quarterly reports published to date.

²⁶ The zero portfolio growth for SG and NSG leads to a level of disbursements in the simulation that exceeds several times the actual undisbursed balances

- 2.18 Similarly, the operation-by-operation, additive approach inherent in the CAP does not sufficiently account for portfolio covariances. The CAP aggregates risk by each individual operation at the NSG level, and by country at the SG level, without accounting for specific correlations between exposures. For SG, all operations in a country are assumed to behave identically in the event of the country's default. In rating an NSG transaction, the Bank factors in the risk of the country in which the operation is located, but does not cross-reference other considerations such as global or industry risks that affect certain operations. Apart from country risk covariances, there are macroeconomic, sector, sponsor, and commodity factors that may cause the risks of individual operations to be correlated with each other. The operation-by-operation approach used by the CAP does not ensure the consistency required to systematically account for these risks.
- 2.19 This is particularly relevant for the Bank, which has a highly concentrated country portfolio. Five borrowers account for about 70% of the Bank's outstanding loan balance.²⁷ Simultaneous default events represent a potentially substantial risk to the Bank's capital base. Yet the Bank allocates capital individually to country exposures as estimated by external rating agencies, and attempts to connect them by using a proxy to represent the covariance of these—arguably very unlikely—sovereign default events. Unlike such MDBs as the World Bank and Asian Development Bank (ADB), the Bank does not draw on its high knowledge of each borrowing country to develop internal risk estimates. Management is aware of this shortcoming, and is revising the modeling approach to a multifactor model to take such correlations into account.

C. Fund for Special Operations

- 2.20 The FSO, the Bank's concessional lending window, had already undergone structural changes before IDB-9. Established along with the Bank, the FSO was designed to provide loans under concessional terms to all borrowing members.²⁸ Amid a growing financial strain posed by the long repayment schedules, the FSO started restricting country eligibility, until eventually only the poorest borrowing countries—Bolivia, Guyana, Haiti, Honduras, and Nicaragua—remained eligible. In 2006, the Governors requested that the FSO (i) provide 100% cancellation of the stock of debt of the five FSO-eligible countries as of 2004; (ii) continue providing concessional lending to Bolivia, Guyana, Honduras, and Nicaragua by blending FSO resources with OC; (iii) provide only grants to Haiti; and (iv) continue financing an annual technical cooperation program with FSO net income. The Governors expected this to be done without any capital infusion to

²⁷ Argentina, Brazil, Colombia, Mexico, and Peru, none of which has an AA+ or better rating. While Brazil, Colombia, and Peru have seen improvements in their foreign-currency rating, Argentina, which accounts for 16% of the Bank's total sovereign exposure, is on negative outlook with a non-investment-grade rating (B), and Mexico has a BBB rating with a stable outlook.

²⁸ FSO loans had a maturity of 40 years with a 10-year grace period and 1% fixed interest rates for the first 10 years and 2% fixed rates for the remaining 30 years. In the 1970s the FSO started providing an "optional currency program," allowing countries to borrow in US dollars and repay in their local currencies.

the FSO; consequently, this led to an overhaul in the manner in which the Bank provides concessional resources, with the introduction of a blended lending approach.²⁹

- 2.21 At the time of the IDB-9 negotiations, the FSO's financial situation was already severely strained.³⁰ The IDB-9 negotiations ended up focusing on the replenishment of the Bank's OC, deferring major action on the FSO for negotiations to be held before 2020. Only short-term actions were decided during IDB-9: capping administrative expense charges by the Bank to the FSO at 3%; relieving the FSO of its contributions to Haiti by mandating that Haiti grants be supported by OC; and providing US\$479 million in additional IDB-9 resources to the fund to offset the canceling of Haiti's outstanding debt. The Governors did not specifically mandate that Management implement any additional actions. However, their commitment "to ensuring that the FSO is fully replenished for the next decade"³¹ implies that measures will be taken to ensure the sustainability of the Fund until 2020, when the Governors will review the need for a new replenishment. Unlike the World Bank's International Development Association, the FSO has not had a regular schedule of replenishments from members.
- 2.22 Management has broadly satisfied the actions required by IDB-9 in connection with the FSO. Actions included cancelling Haiti's outstanding debt, reducing administrative charges, and extending the currency conversion obligations. Management has produced a 2011 FSO LTFP and a 2012 FSO LTFP, which, as the IDB-9 requires, actively assess the ability to "ensure sustainability" of the FSO in preparation for potential negotiations by 2020. Yet, in a technical briefing (October 2012), Management warned that the FSO will not be able to maintain its current lending rates until 2020 unless liquidity issues are addressed.³² Management indicated that disbursements were faster than originally projected in the 2011 FSO LTFP, and returns on balances were lower than expected because of prevailing return rates. Management proposed two mechanisms to ensure the FSO's sustainability. First, Management suggested converting the convertible currency liquid holding in the FSO into US dollars. Additionally, considering the lack of availability of local currencies in the OC, Management proposed that the OC purchase local currencies from the FSO to pay for its share of local currency administrative expenses, thus increasing the FSO dollar holdings. The Board requested further analysis, and a report is expected by Q1 2013.

D. Risk Management Framework

- 2.23 The IDB-9 Agreement emphasized the importance of successfully completing various actions to strengthen the Bank's Risk Management Framework. Efforts to

²⁹ The blended lending approach is a mix of OC-FSO loans that provides varying degrees of concessionality according to the country's debt sustainability analysis.

³⁰ The strains were partly the result of providing debt relief in 2006 and 2007 as requested by the international community.

³¹ Cancun Declaration, para. 6.

³² 2012 FSO LTFP Technical Briefing

strengthen the Bank's risk management have been in motion since the Bank's 2007 realignment, and before IDB-9 they were being carried out under the "Agenda for a Better Bank."³³ Recent reforms included the establishment of an independent Risk Management Group, the development of the CRCS, and the development of comprehensive risk taxonomy as a means to map risk exposures.³⁴ Through IDB-9, the Governors mandated that the Bank deepen these reforms to ensure "that IDB's risk management practices and capabilities meet international best practice standards."

- 2.24 The IDB-9 Report described the measures expected by Governors: (i) *Governance*: strengthen the Board's oversight function with respect to financial matters, and adjust the terms of reference of Management's Asset and Liability Committee (ALCO) to improve the Bank's effectiveness and help it adapt to fast-changing market conditions; (ii) *Policies and strategies*: align Bank practices to modern financial industry standards, update and streamline the asset and liability management framework, and review and adjust the investment strategy and liquidity policy; and (iii) *Bank's analytic capacities and systems for risk management*: complete a new CRCS for the NSG portfolio to improve the quality of the Bank's credit risk assessment, and develop the new Integrated Capital Adequacy Policy and Portfolio Analytics system (ICAPA)³⁵ and an operational risk framework to improve coordination of the management of operational risks at the business unit level. The Bank has made considerable progress in implementing these IDB-9 requirements.
- 2.25 Yet risk management is inherently a long-term process, and effectiveness is built over time. Thus, new areas of focus—such as operational risk—are still in a nascent stage, and not up to par with industry standards. The Operational Risk Framework was formally created in August 2012, with a strategy that consists of working with different units of the Bank to strengthen internal risk mitigating processes. The framework is still new, and the Bank is still fine-tuning the scope of work and tools of the Operational Risk Committee. Even though the Bank has a solid work plan to implement a system that will seek to mitigate operational losses throughout the Bank, it projects that the work plan will not be fully implemented until at least three years from now. Reaching this stage of full implementation is also contingent upon successfully establishing a solid framework that covers all units of the Bank.

³³ The Agenda for a Better Bank describes the actions considered necessary to maximize the effectiveness and impact of IDB's interventions in the context of the General Capital Increase, focusing on Management's functions and operations. It includes initiatives that have been implemented over the last several years (such as those related to the Risk Management Framework), as well as new actions proposed by Management and the Board.

³⁴ The Board approved the risk taxonomy in May 2010. It identifies five broad risk components (strategic, financial, compliance, operational and environmental and social risks). Financial risk, in particular, encompasses five dimensions: credit risk from borrowers and counterparties, market risk, liquidity and funding, external financial reporting, and capital structure.

³⁵ The ICAPA houses the Capital Adequacy and Balance Sheet Management, Portfolio Analytics and Risk Management, and Financial Projections and Asset Liability Management.

- 2.26 Also, a large portion of the Bank's risk data aggregation will be dependent on the new ICAPA, which still has some shortcomings. While it can now pull together data from various systems for consistent application to different risks and portfolios, there are still programming errors and time lapses. A related issue is the consistency of risk assumptions over the different categories of risk. While ALCO meets in the context of specific situations, there is no common repository of risk assumptions that all areas can refer to. Risk assumptions are determined on a case-by-case basis, so areas working on different risk perspectives can be working with incompatible assumptions, thus detracting from a unified perspective and overall consistency.

III. IMPLEMENTATION EFFECTIVENESS

- 3.1 The IDB-9 mandates relating to the Bank's risk and financial management architecture touched on five explicit and implicit objectives: (i) preserving the Bank's AAA rating, (ii) ensuring self-sustainability, (iii) increasing lending capacity to better meet borrowers' demands, (iv) promoting the Bank's capacity to lend countercyclically, and (v) providing competitive loan charges through lower funding costs and a transparent loan pricing methodology.³⁶ There are trade-offs among these goals, as this section discusses.

A. Preservation of AAA Rating

- 3.2 According to the methodology used by the two major ratings agencies with published Multilateral Rating Criteria (S&P and Fitch),³⁷ three critical elements contribute to the preservation of an MDB's AAA rating:³⁸ the *stand-alone capital profile and earnings capacity*, followed by the institution's particular *risk position*, and its *liquidity profile* (see Box 1 for a description). Combined, these factors underpin the MDB's long-term solvency and its short-term ability to service upcoming debt obligations. Rating agencies also factor in two other elements in the overall rating methodology: *callable capital*, although giving it less importance, and the MDB's *preferred creditor treatment* (PCT).³⁹

³⁶ Competitiveness was not an explicit objective pursued by the Governors. However, OVE found it a necessary objective of this evaluation, given the changing landscape of MDBs and the Region.

³⁷ See Annex for an overview of each agency's methodology.

³⁸ Of the three major rating agencies, S&P is the only one that has continuously rated the Bank's debt issuances. Fitch has recently started rating the Bank's obligations, while Moody's has yet to rate the Bank.

³⁹ Preferred creditor treatment refers to the fact that borrowing member countries treat obligations to IDB and other multilaterals as claims that are senior to any other debts.

Box 1. Rating Agencies' Methodologies for MDBs: Key Drivers (see Annexes B and C)

Stand-alone capital profile. The MDB's stand-alone capital profile relative to risk is the most critical component in the overall rating. S&P views stand-alone capitalization as the cornerstone of an MDB's rating. Its recently adopted MDB methodology uses a risk-adjusted capital ratio as the key determinant of the AAA rating, measuring the MDB's adjusted common equity (bank sheet capital) against its risk-weighted assets. Similarly, Fitch gives the largest relative weights in its overall rating roadmap to "Capitalization" (30.5%), and the related aspect of "Credit Risk" (20%). Additionally, the MDB's profitability and its ability to generate earnings are becoming increasingly important in the view of rating agencies' capital adequacy analysis. Profitability and earnings capacity come from a mix of revenue-generating activity. Fitch gives profitability a weight of 5% in its rating roadmap. S&P factors in earnings into the risk-adjusted capital ratio with a forward-looking analysis that measures the MDB's earnings capacity. Rating agencies emphasize the importance of high-quality earnings. That is, if profitability and capital accumulation are tied to loan and fee income, they tend to be fairly stable and predictable. However, if capital accumulation depends on other sources of income such as return on free funds, earnings can be subject to considerable market risk and are considered to be of lower quality.

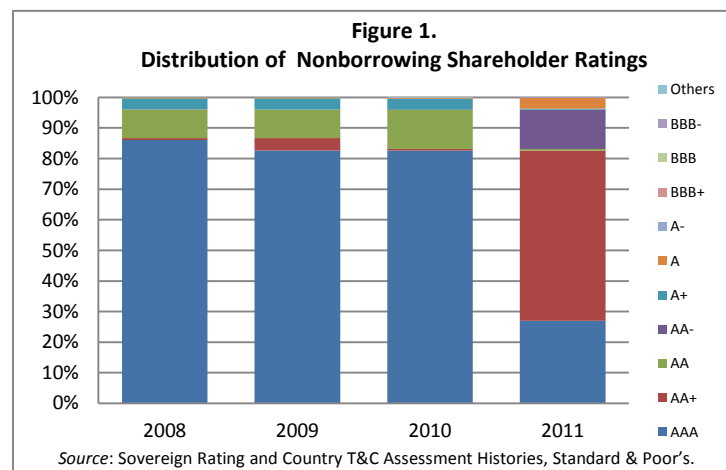
Risk position. Rating agencies pay particular attention to risks that are not captured in the capital adequacy assessment, mainly concentration risk. S&P's new methodology assesses the institution's risk position by adjusting the risk-adjusted capital (RAC) ratio to take into account concentration for sovereign exposures, as well as its PCT, which is now a function of a sovereign's long-term credit rating and share of multilateral debt. Fitch gives concentration risk a weight of 5%. Additionally, rating agencies assess any material changes in an MDB's risk management and loss experience. For instance, S&P views an MDB's risk management as positive if it has conservative risk tolerances and stays focused on its core activities while prudently approaching new business. It also views loan performance by taking into account past-due loans to a soft loan window or debt forgiveness effected off balance sheet as an indicator of loss experience.

Liquidity. Rating agencies view the size and quality of an MDB's liquidity profile as critical to its overall rating. Fitch measures an MDB's ratio of liquid assets to short-term debt, and gives this a weight of 12.5% in its rating. S&P's assessment of an MDB's liquidity and funding profile can elevate the capital adequacy assessment by one notch or lower it by as many as five notches. Under S&P's new methodology, this assessment is now more demanding: it not only analyzes the structural match between the duration of an MDB's assets and its liabilities in the current year, but also assesses if there is a significant gap over a five-year horizon. Moreover, it introduces punishing stress tests to measure an MDB's ability to manage liquidity needs in adverse market and economic conditions. This includes applying various risk "haircuts" on liquid and maturing assets and testing for liquidity gaps on a 3-, 6-, and 12-month forward-looking basis.

- 3.3 Because each component of the risk and financial management architecture mandated by IDB-9 was designed with different objectives, the whole ended up providing an uneven level of support to the Bank's AAA rating. The IMM, CAP, and risk management actions were designed with an internal focus, without systematic consideration of the influence that they might or might not have on the perception of the Bank among rating agencies. As a result, some of the introduced mechanisms support the AAA rating; others are burdensome but irrelevant to agencies' views; and others require a renewed focus to preserve the AAA rating—

such as the reduced weight of callable capital in rating considerations. This last item is highlighted as major change in S&P's newly announced MDB rating criteria.

- 3.4 The Bank is expected to maintain its strong stand-alone capital profile. According to S&P and Moody's, the IDB is adequately capitalized, consistent with the AAA rating. However, a review of external agencies' changes in rating criteria indicates a much stronger focus on shareholder equity versus callable capital. The recent capital increase consisted of 97.5% callable capital, representing the Bank's historically largest reliance on callable capital, which contrasts with that factor's declining importance for rating agencies. Recent changes in nonborrowing shareholders' ratings have reduced the overall support for callable capital⁴⁰ (see Figure 1). S&P only factors in callable capital from shareholders with a AAA rating, if there is current, appropriately detailed, and approved documentation of call procedures (see Annex D). Rating agencies also look at shareholders' ability to follow through on capital increase commitments in a timely manner as a precursor to the ability to make a successful call on capital.⁴¹ Rating agencies can view the February 2012 delay in the first capital subscription as another potential weakness, as is the precedent set by delayed contributions to the Inter-American Investment Corporation. Thus, the relatively small amounts of paid-in capital, exacerbated by the annual transfers to the Grant Facility, make the Bank's earnings capacity, a key driver of maintaining capitalization levels in the long-run, consistent with a AAA rating.



- 3.5 In fact, the Bank's earnings capacity is likely to change with developments in the NSG business, potentially requiring some adjustments to support the AAA rating. Expanding private sector operations (as indicated in IDB-9), or changing the relationship of these operations within IDB through a potential merge-out, has implications on the Bank's capitalization levels. To support the AAA rating,

⁴⁰ For instance, S&P only accounts for callable capital from members with a triple-A rating. The recent U.S. and Spanish downgrades weaken the IDB's callable capital subscription.

⁴¹ For example, Fitch has a separate variable "history of support" in its rating roadmap, based on the size of capital increases or other means of financial support from shareholders.

earnings growth deriving from NSG expansion within the Bank will need to be accompanied by appropriate measures to account for the Bank's potentially increased risk.

- 3.6 The IMM and CAP, however, are less effective in guiding capitalization needs in the event of large changes in portfolio composition, like the one envisioned with the growth of NSGs. A capital accumulation strategy needs to be supported by a forward-looking capital planning process, taking a long-term view of the Bank's risk profile given the expected changes in the portfolio composition.⁴² This way, the Bank can gradually allocate enough capital to support its future risk-taking activities, which is critical for its rating. The IMM now uses the Bank's current risk exposures determined by the CUR and its desired bands, which are volatile from year to year, to determine how much capital to accumulate. This implies that IDB might not be accumulating enough capital to support these portfolio changes. For capital planning purposes, most MDBs, such as the ADB,⁴³ link capital accumulation decisions with risk-based capital requirements of a target portfolio in the 10th year through stable parameters.
- 3.7 To preserve the AAA rating in the long-run, it is important to understand how the lending composition will look in 5 and 10 years. The Bank can then accurately determine the amount of capital required and support the calibration of a stable operational band that should be reviewed periodically, to support capital accumulation on a forward-looking basis. It is also advisable that the Bank consult with rating agencies on the appropriateness of significant changes expected in the portfolio composition to ensure that the planned financial profile will be consistent with a AAA rating.⁴⁴
- 3.8 Additionally, the Bank may need to address concentration risk in its lending portfolio in light of rating agencies' higher penalty on this risk factor. The Bank exhibits high concentration risks.⁴⁵ S&P, in its next rating cycle in 2013, will start taxing the Bank for its high concentration levels, reflected in the adjusted RAC ratio. While this change will be partially offset by the PCT, any downward moves in borrower ratings will reduce the PCT adjustment, which can lead to a higher concentration cost. Other MDBs (see Annex A), such as ADB and AfDB, are

⁴² For example, other MDBs (IFC and EBRD) introduce stable ratios based on prudent long-term estimates of banking risk in their various exposures to their capital management.

⁴³ The ADB Capital Adequacy Framework determines how much capital is required for the risk the Bank faces by factoring in the simulation the share of nonsovereign operations in the annual commitment that is in accordance with the parameters outlined in the long-term strategic framework with regard to the planned increase in annual nonsovereign lending to 50% by 2020.

⁴⁴ For instance, the Bank may consider using S&P's Risk Evaluation Service. In its current version, the Bank provides a projected financial profile some years out—e.g., five years—and S&P convenes a quasi-rating committee and decides whether the Bank, with that financial profile, would still be rated 'AAA'. If the financial profile is consistent with the projected one, the Bank has in effect bought an "insurance policy" on S&P's rating, assuming rating criteria do not change.

⁴⁵ Seventy percent of the Bank's portfolio is concentrated in five sovereigns, none of which has a AA+ rating.

addressing concentration risk through their CAPs.⁴⁶ Once the CAP reflects these concentration risks, the Bank will need to assess the trade-off between establishing explicit lending concentration limits by country and allocating more capital to the SG portfolio.

- 3.9 The Bank's liquidity policy is conducive to maintaining the AAA rating. Rating agencies assess whether an MDB has enough liquidity to cover its short-term debt on a forward-looking basis. S&P takes a step further, measuring the Bank's ability to survive under adverse market conditions by applying "haircuts" to its liquid asset investments. The Bank's liquidity policy is in line with this requirement by tying the size of the liquidity portfolio to cash flow projections.⁴⁷ However, the current composition of the Bank's liquidity investment portfolio might not pass S&P's harsh stress tests, since it still has exposures in riskier assets, such as mortgage-backed securities. While Management has taken steps to reduce exposure in these riskier assets, the effect of this run-off will not be immediate as these markets are still somewhat illiquid. Thus, this may provide a weaker support to the Bank's rating in the short run.

B. Self-sustainability

- 3.10 Governors implied, but did not clarify, the intended level of financial self-sustainability that the Bank was to achieve with IDB-9. Governors alluded to making the Bank more self-sustainable and using retained earnings to support self-capitalization, but strategic decisions that would indicate the extent of this self-sustainability goal were not part of the IDB-9 Agreement. Without this guidance, it is not possible to properly set the constraints introduced in the models to direct the Bank's activities—for example, whether the IDB-9 planning horizon finishes in 2020 or is meant to always project 10 years out into the future. In turn, since these constraints directly affect loan charges and the sustainable level of lending, setting them without guidance can lead to distortions, inappropriate incentives, and unintended consequences.
- 3.11 Because of this vagueness in the desired self-sustainability level, certain CAP and IMM parameters had to be arbitrarily defined, rather than set to advance a unifying Bank financial strategy. The Governors introduced three constraints in IMM to guide the Bank toward a higher level of self-sustainability: (i) an ACR, (ii) an operational band to link the Bank's capital accumulation with risk-based capital requirements, and (iii) a long-term planning horizon, illustrated until 2020 in the IMM Annex to the IDB-9 Report, which at the time was also equivalent to "10 years out into the future." However, these constraints do not provide a unique

⁴⁶ ADB adjusts risk profiles for concentration, which results in a higher economic capital charge for its lending portfolio. AfDB uses its capital adequacy to guide global exposure limits.

⁴⁷ The upper liquidity band is calculated by projecting the amount of cash the Bank will require to support 12 months of dynamic contractual debt repayments and one and a half times the estimated highest consecutive 6 months of loan disbursements over an 18-month period. The lower liquidity band is based on 6 months of debt repayments and half of the consecutive 6 months of loan disbursements.

solution regarding loan charges. They rather produce a range of allowed combinations of charges and other parameters—e.g., expenses—but no guidance for choices within this range.

- 3.12 The lack of a definition may have unintended consequences. For example, the ACR can either create incentives for a more disciplined institution, or motivate the reduction of expenses at any cost. For the first time in the Bank's history, there is now a direct connection between expenses and borrowers' loan charges. This may have the powerful effect of promoting doing more with less—which was probably what most shareholders intended. However, this may also come at the expense of reducing the Bank's competitiveness through higher loan charges or excessive expense reductions that can reduce the ability to support innovation or difficult development situations. To set the ACR at a level that creates incentives for the desired behaviors, the Bank should take these trade-offs into account and weigh them against the objectives of the organization.
- 3.13 Similarly, the CUR operational band constrains, but is insufficient to direct, the Bank's capitalization activities. As explained above, the Bank's long-term target portfolio and capitalization strategy should drive the risk profile and the corresponding capital needs of the Bank. Thus, self-sustainability requires a capitalization strategy that is based on a clear understanding of the future composition of the Bank's portfolio as well as the expectation and likelihood of future capital increases. However, while the Governors did not rule out the expectation of future capital increases, they also did not affirmatively state it. Similarly, while it was vaguely stated that NSG would grow at the expense of SG operations, there is no explicit vision of the Bank's future portfolio composition. The current implementation of the IMM and CAP assumes incremental capital accumulation, but this level may not align with the long-term level required to support the AAA rating. As a result, the operational band may ensure proper capitalization in steady state, but is unable to guide capitalization and risk appetite in a context of uncertainty.
- 3.14 Finally, the ambiguity in the extent of self-sustainability may also affect loan charges through a long-term planning horizon that is potentially longer than necessary. As a general rule, longer planning horizons are more constraining, and thus increase the probability of higher loan charges. While the IMM supports a sustainable lending level of US\$12 billion over a 10-year planning horizon, the Governors did not articulate whether this was to be extended beyond 2020. It is also unclear if this level would be supported by internally generated income, future capital increases, or both. The adoption of the IMM has forced Management to make assumptions as to how long the Bank is to self-sustain with internally generated income. Currently, Management assumes that US\$12 billion in annual approvals will be supported only until 2020, which means the Bank will then need to face a choice between new capital or sharply reduced lending (to about US\$6 billion). Given that IDB capital increases have been complex and rather infrequent, this assumption is not trivial.

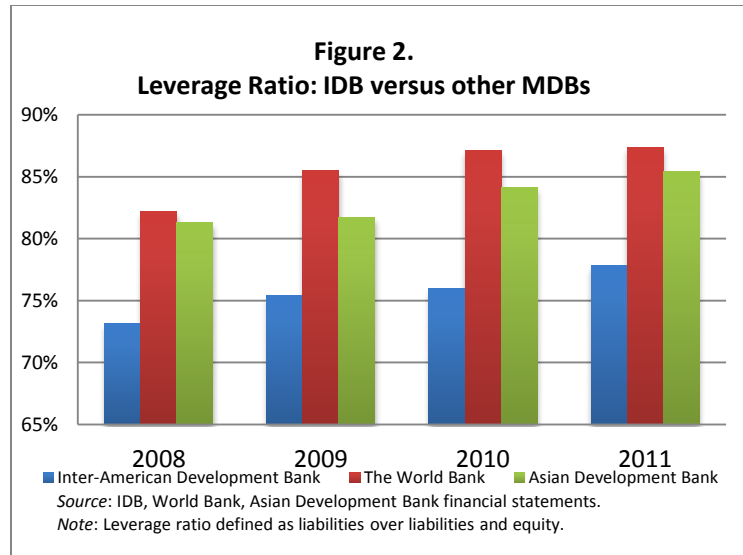
C. Increased lending capacity

- 3.15 An objective of the IDB-9 capital increase was to step up lending to the LAC Region.⁴⁸ The Bank can have two constraints on lending: the borrowing authority limit⁴⁹ and capital. The former limits the Bank's net borrowings to the amount of callable capital from nonborrowers; the large amount of callable capital from IDB-9 aimed at addressing this constraint. The latter refers to the amount of capital necessary to cover the Bank's risk-bearing activities, which was addressed through the relatively small increase in paid-in capital and a capital accumulation rule to increase retained earnings.⁵⁰ The Governors decided on a yearly sustainable level of US\$12 billion for the IDB-9 period, subject to annual approval by the Board. However, the IDB-9 reforms have not actively addressed how the Bank's financial and risk management architecture could potentially support lending beyond the US\$12 billion envelope, either through mechanisms to increase net borrowings or through a defined capital accumulation rule to build additional equity.
- 3.16 In fact, the Bank's sustainable lending level is still constrained by the borrowing authority limit. This limit was introduced during IDB's first bond issuance, more than 50 years ago, and reflects an outdated risk management tool (see Annex E, question 4, on the Impact of the Unused Borrowing Capacity Buffer on the Bank's ratings). The IDB is the only MDB, out of those that were benchmarked, that constrain their debt levels on the basis of callable capital. As rating agencies are reducing the role of callable capital in their consideration of MDBs, the relevance of the "implicit call" scenario embedded in this borrowing restriction is called into question. In fact, the unused borrowing capacity (UBC) constrains IDB far more than other MDBs, such as the World Bank and ADB, which present higher leverage ratios (see Figure 2). Thus, the Bank may be able to modestly increase its lending capacity by removing this self-imposed limit and replacing it with a more appropriate risk-based measure.

⁴⁸ At the 2009 Annual Meeting in Medellin, Governors requested an estimate of potential financing demand for the Region, and Management returned with three lending scenarios at US\$18 billion, US\$15 billion, and US\$12 billion.

⁴⁹ The unused borrowing capacity is calculated as the Bank's callable capital from nonborrowing member countries minus gross debt plus gross guarantee exposure minus liquidity.

⁵⁰ The IMM was designed to help build equity to support higher lending levels over the long run, but, as mentioned before, a strategy for capital accumulation was not defined.



- 3.17 By updating the financial and risk architecture, the Bank could potentially increase lending. Management should explore adopting new risk constraints that are more suitable to the Bank. Other institutions use gross ratios to limit debt relative to capital. For instance, the IFC's leverage policy consists of ensuring that the ration of its drawn debt, including guarantees, to the total subscribed capital and accumulated earnings, does not exceed 4:1. Similarly, the Andean Development Corporation (CAF) caps its leverage at 3.5 times equity. Management should explore these options with the backing of investors and rating agencies.
- 3.18 The Bank's borrowing authority is further constrained by a UBC buffer, which could be reduced if some borrowing countries agreed to contractually reduce volatility in disbursement patterns. The UBC is a risk management tool to protect the Bank from a breach in its policy-based borrowing authority by, among other things, accounting for volatility in loan disbursements. The Bank is already exploring ways to use the UBC for newly proposed lending products, but this buffer could be reduced even further if this action were coupled with contractual measures to control unnecessary variations in disbursement patterns. Controlling disbursement patterns through contractual measures might be a difficult initiative to agree upon and implement. However, the alternative of maintaining "business as usual" signals a cost to the Bank's financial architecture in terms of lending capacity and loan charges.
- 3.19 The UBC also serves to reduce the likelihood of a call on capital, and could be reduced if some countries agreed to support the Bank with a guarantee of expeditiously honoring a call within a predefined period. Similarly, the risk of making a call on capital could be mitigated by various alternatives, such as introducing distinctions in the Bank's capital structure. For instance, certain shareholders could commit to convert their contributions to a separate category of callable capital, which would be "more amenable to being called," i.e., transformed into paid-in capital, within a certain period, possibly five years. This would require somewhat of a paradigm change, as capital calls are thought of as

“sure death” events for MDBs, events to be avoided at all costs. However, these “managed capital calls” would allow the Bank to further leverage, and still have access to, the necessary collateral, within a predefined time window.

D. Countercyclical lending capacity

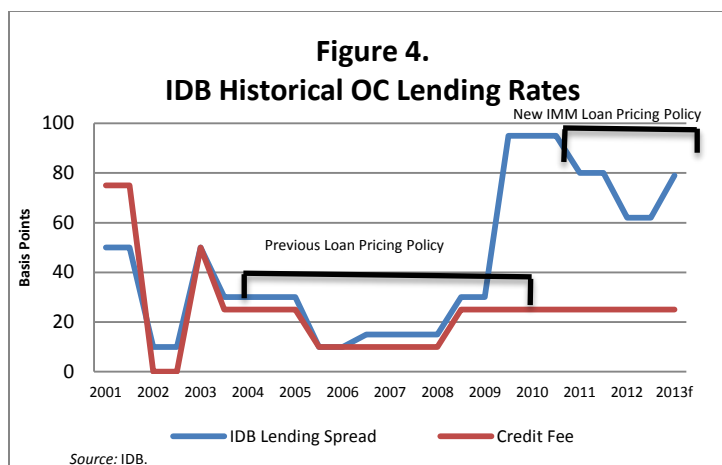
- 3.20 The IDB-9 objective of achieving sufficient countercyclical lending capacity was not fully articulated, since the Governors never clearly stated the degree of “counter-cyclical coverage” they expected to achieve. During the IDB-9 negotiations, the Governors emphasized the importance of maintaining IDB’s significant countercyclical support role in the Region, and thus mandated that the models manage the Bank’s income and capital to support this countercyclical objective. However, the Governors did not define what being countercyclical would mean for the Bank, including the amount they were willing to support, their risk tolerance for this type of lending activity, and their consideration of the potential trade-offs this would entail in terms of competitiveness and lending. Consequently, the status quo was largely maintained, with only marginal additions to the Bank’s countercyclical capacity.
- 3.21 Currently, the Bank relies only on front-loading and two recently introduced countercyclical lending instruments—the Contingent Credit Line and the Development Sustainability Line—to increase lending during downturns. Front-loaded lending implies that future approvals would need to be reduced in subsequent years. Alternatively, the new mechanisms can accommodate countercyclical demand up to US\$5 billion in a given year. However, the Bank only has countercyclical headroom until 2015 as incoming capital contributions are received as a result of IDB-9. Thus these instruments constitute only a temporary fix that may fall short of LAC’s needs. If another crisis were to hit the Region, these lending mechanisms would overstretch the capital base, and, as under the previous crisis, the Bank would likely have to drastically raise SG loan charges.
- 3.22 Since the Governors did not articulate the “countercyclical coverage” they desire for the IDB, the CAP and IMM may not be preparing the Bank for the countercyclical lending LAC requires. Since the existing mechanisms provide countercyclical lending capacity only in the short term, the CAP and IMM would need to be designed and managed to build reserves while protecting the Bank’s equity. However, certain factors and mechanisms that are not being taken into account limit the Bank’s ability to lend countercyclically throughout the entire IDB-9 period.
- 3.23 The Bank’s countercyclical lending capacity is constrained by the inherently procyclical CAP. The CAP, applied to a fixed capital base, reduces lending portfolios when they become riskier. Under “strained” conditions, such as a selective default of a large borrowing country, the CAP determines that the CUR desired bands will increase, to reflect that more capital is required for the increase in risk exposures. This causes a reduction in the sustainable lending program, thus making the CAP procyclical. Additionally, if the Region suffered a prolonged

financial crisis that translated into a progressively deteriorating portfolio for the Bank, the countercyclical mechanisms of front-loading would represent additional pressure to the CUR and further decrease the Bank's future lending envelope. Other MDBs have reconciled this countercyclical objective with their internal capital adequacy models by introducing stable ratios that factor in a medium-term view of the necessary countercyclical headroom they are seeking to reserve, which the CAP does not do.

- 3.24 Additionally, the IMM is not using SG loan charges to build reserves that could be targeted at gradually creating additional countercyclical headroom. The capital accumulation rule embedded in the IMM creates the incentive for minimum loan charges, which means that the Bank is missing the opportunity to calibrate loan charges to build up equity for countercyclical purposes. Consequently, the Bank risks not being able to support the Region's countercyclical needs over the long run. The definition of a capital accumulation rule would need to be calibrated against the desired level of countercyclical support—which itself needs to be clarified by the Governors and the Board—to guarantee full effectiveness.
- 3.25 Even if the CAP and IMM are designed to build reserves for countercyclical purposes, building retained earnings to support this type of lending activity is a slow process. If the Bank needed to lend countercyclically on short notice, it would be constrained in its ability to add more risk to its balance sheet. An alternative, although untested, would be to find a mechanism to sell existing loans and reduce risk on its balance sheet, to free up its lending capacity for countercyclical purposes.

E. Competitive loan charges

- 3.26 The IMM, and to a lesser degree the CAP, define SG charges through a predominantly inward-looking process. Though the IMM does build stronger linkages between the Bank's revenue and expenditure streams as intended, it may also limit the Bank's ability to respond to competitive pressures. Loan charges are set to satisfy certain conditions, resulting in a floor that is substantially higher than charges under the prior Bank policy, which emphasized competitive and stable loan charges as a primary objective. While loan charges under the former policy spiked in 2009 during the financial crisis, they have remained high under IMM despite the recent increases in paid-in capital (see Figure 4). The main reason for this high floor has been the ACR, which has been highly constraining, setting the loan pricing methodology on a path that leaves a narrow window for competitive pricing versus other MDBs serving LAC.



- 3.27 In addition, the IMM introduces more lending rate instability, as it ties loan charges to parameters that have a high degree of uncertainty, such as expenses and disbursements. For example, OVE estimates that a 10% increase in administrative expenses will increase loan charges by up to 10 bps. Measures to reduce the volatility stemming from unstable parameters in IMM could include designing the coverage rule to account for only lending-related administrative expenses.
- 3.28 IDB will likely remain competitive in the short term because of its lower funding costs, but the fact that its financial architecture lacks a clear market orientation merits strategic consideration. Benchmarking loan charge competitiveness across various MDBs is no simple task, given that MDBs offer different loan products, with different terms and structures. Yet, comparing the various components that determine the final cost of a loan gives a general idea of the Bank's relative competitiveness. Most MDBs, including IDB, incorporate a direct pass-through mechanism into the final loan product, passing funding costs on to borrowers. As the previous section discussed, a higher rating allows the Bank to borrow at lower rates, and thus reduce rates to borrowers.
- 3.29 However, when the Bank's rating is viewed in the context of emerging competitors such as CAF,⁵¹ IDB's financial competitive advantage will likely weaken over time. While CAF's lower rating means its cost of borrowing is higher, this spread has narrowed considerably—S&P now gives CAF an A+ rating. Furthermore, under the new rating methodology proposed by S&P, CAF's reliance on balance-sheet (as opposed to callable) capital favors its approach and places it on an upward course to higher ratings. Thus, for the Bank to remain competitive, strategic considerations as to what role the Bank expects to have in the Region will need to be incorporated into its loan charge methodology.

⁵¹ CAF is growing in importance and relevance in the Region, with capitalization levels that have increased by over 50% since 2007 because of a growing shareholder base and high levels of paid-in capital. While there are portfolio composition differences, with IDB having a somewhat larger presence in Central America and the Caribbean, CAF's portfolio is projected to grow and surpass the IDB's within the next 10 years.

Similarly, the Bank's approach toward capital increases will need to be contrasted with CAF's almost continuous capital increases, smoothly subscribed, mostly by its own borrowers.

- 3.30 While the IMM reduces the Bank's maneuverability in terms of loan charges, other factors, such as value-added product mixes or the agility of project preparation, can enhance IDB's competitive edge. As OVE observed in its ongoing evaluation on "How IDB is Adapting its Business Model in Higher-Middle-Income Countries," the average period between approval of a project and first disbursement is between 9.1 and 10.6 months. This contrasts with CAF, in which the shortest time period between approval and disbursement can be 2 months, while the average is 6 months. This broader focus on ensuring a competitive Bank was not actively addressed during the IDB-9 negotiations, and consequently, was not integrated as an element of the Bank's financial and risk architecture endorsed by the Governors.

IV. SUGGESTIONS GOING FORWARD

- 4.1 IDB-9 addressed the immediate constraints on equity and borrowing through paid-in and callable capital injections to support a US\$12 billion sustainable lending level. Governors accompanied these commitments with tools, mainly the IMM and CAP, designed to manage the Bank's income and capital and to foster greater efficiency and transparency. These tools have introduced more discipline into the institution and represent an improvement in the Bank's financial and risk management. OVE suggests introducing flexibility and market-responsiveness in IMM and refinements to the Bank's capital management. OVE also suggests updates to financial and risk tools that may overly constrain lending, particularly the UBC. Lastly, OVE suggests that the IDB-9 financial and risk models take a more proactive role in assessing the inherent trade-offs between the various long-term objectives pursued by the Governors to provide additional support for the Bank's strategic decisions.

A. Introduce flexibility and market responsiveness in the IMM

- 4.2 OVE's findings indicate a number of immediate issues to be further discussed in refining the Bank's IMM. Among them is the current requirement for one overall expense coverage, which is set at a rather high level in comparison with other MDBs. This may "strait-jacket" the Bank's ability to respond to competitive pressures. By not increasing its market responsiveness, IDB may risk harming its competitive position in the Region. Given the Region's accelerated growth, countries have been able to access lower market financing rates, reducing the value added by IDB. Thus, OVE suggests that the Bank consider keeping some flexibility in its decision-making process, tailoring IDB-9 financial models and other tools to capture market trends.
- 4.3 OVE suggests that the Bank explore the option of setting an administrative coverage band, rather than a fixed ratio for the IMM ACR. This would allow the Bank to operate within a range of coverage ratios over a given time horizon, thus giving it some flexibility to price more competitively, while still on average maintaining the discipline required by the Governors. The Bank may also want to consider excluding certain nonoperational (investment and pension) expenses from the coverage requirements.

B. Refine the Bank's capital management

- 4.4 OVE suggests strengthening the Bank's capital management and planning processes to ensure preservation of the AAA rating in the long run. This includes further refinements in the CAP, which determines how much capital is required for the risks that the Bank is facing. First, the Bank needs to review its capital reserve ratios for its lending portfolio, in particular the relative ratios for SG and NSG lending, as the Bank now appears to be relatively lenient on NSG vis-à-vis SG lending compared to other MDBs. Second, the assumptions on loan approvals and disbursements used in the IMM could also be used for the CAP, as they

represent more realistic estimations of the changes in the portfolio composition. Third, OVE suggests further consideration of concentration risks, an issue of growing concern among external rating agencies.

- 4.5 Additionally, OVE suggests that the IMM's role of guiding capital accumulation follow comparable industry standards. The capital accumulation rule was adopted directly as it was expressed in the IDB-9 text—"Capital should be accumulated over a rolling five-year period to place the CUR within the desired band"—without placing any other constraints. However, a capital accumulation rule defined only by the boundaries of the CAP creates volatility in the Bank's capital management. Management should consider introducing stability in the capital planning process by developing a stable operational band, based on a framework that takes into account a long-term view of the desired portfolio composition, IMM loan growth projections, sources and uses of income, and linkages with projected macroeconomic conditions and the Bank's strategy.

C. Update rules that may overly constrain lending

- 4.6 OVE suggests revisiting and updating the Bank's financial and risk constraints, which are currently capping the annual lending envelope at \$12 billion. In particular, the removal and replacement of the borrowing authority and UBC buffer rules with a more up to date risk constraint may free up additional lending capacity. The removal of this constraint will also align the Bank with rating agencies' view on callable capital: namely that the less the Bank relies on callable capital, the safer it will be perceived. Management has the choice of implementing a leverage cap, or strengthening its capital constraint alongside lending limits, similar to most other MDBs. It is important that this new risk management tool be strict and transparent.

D. Enhance the decision-making role of IDB-9 financial and risk management models

- 4.7 OVE finds that the IDB-9 financial and risk management architecture could further benefit from enhancing its decision-making support capabilities. As implemented, the IDB-9 financial models are predominantly used as safeguards—that is, by providing an assurance of minimum expense coverage. OVE suggests that IDB-9 models be further leveraged by enhancing their usefulness as decision-making tools, more clearly pointing to potential trade-offs as well as helping to assess the implications of business decisions. Specifically, by clearly presenting "sensitivity ratios" and scenarios, Management could further use the financial models to facilitate the Board's decisions on product mixes, alternative products, different levels of expenses, and transfers.

Annex A

Comparator MDBs' Approaches to Capital Adequacy, Loan Pricing, and Risk Management

Six MDBs were included in the benchmarking exercise described in this report. The first two, the IBRD and the IFC are global institutions; the other four are regional institutions.

- *International Bank for Reconstruction and Development (IBRD)* is the oldest and largest of the comparator MDBs and has served as a model, to one degree or another, for all subsequent rated MDBs. The Bank provides only sovereign and sovereign-guaranteed loans and guarantees. It is the keystone of the World Bank Group.
- *International Finance Corporation (IFC)* is the institution within the World Bank Group that focuses entirely on the private sector. Under its charter, IFC does not lend with sovereign guarantees or issue its own guarantees with sovereign counter-guarantees. IFC also makes equity investments as a key part of its business.
- *European Bank for Reconstruction and Development (EBRD)* was established in 1991 to support the development of market economies in the region following the widespread collapse of communist regimes. The Bank makes both sovereign and private sector loans; it also makes equity investments. Sovereign lending has accounted for a diminishing portion of EBRD's business through the years.
- *Asian Development Bank (ASDB)* is in some respects the closest counterpart to the IDB. It makes both sovereign and private sector loans, but historically has focused on the former.
- *African Development Bank (AFDB)* is unusual in that fewer than one third of its regional shareholders are permitted to borrow from the Bank—the remainder must borrow from its soft-loan window, the African Development Fund (AFDF). Historically the focus has been on sovereign lending, but lending to the private sector is slated to grow rapidly in coming years, including in countries to which AFDB cannot make sovereign loans.
- *Corporación Andina de Fomento (CAF)* is a smaller regional institution with a subset of IDB member countries. It makes both sovereign and private sector loans and has a few equity investments.

There is a strong similarity of approaches to capital adequacy and risk management among almost all of the comparator MDBs, with the non-'AAA' rated CAF currently being the outlier. This is not surprising, since the same countries are large shareholders in the other five and share the same concerns across institutions. In particular, managements in all five share a very strong determination to maintain their 'AAA' ratings.

Most MDBs recognize that their capital adequacy modeling efforts cannot directly predict rating agencies' ratings. In part this reflects the fact that the rating agencies' criteria have not been sufficiently transparent to permit such an exercise. Rather, MDBs seek to apply evolving risk measurement best practices to determine what they believe to be very high levels of capital adequacy and discuss their methodologies and results with the rating agencies.

Capital adequacy management is a "work in progress" for most MDBs, who have moved or are moving from a Basel II-type methodology to an economic capital methodology. But not only are there differences in where MDBs stand in the process, but there are also differences in the detail in MDBs' capital adequacy models. To some degree their focus reflects their own historical experiences: in particular, MDBs who have not suffered substantial losses on their treasury portfolios appear to focus less on the risk in those assets.

Finally, it is difficult to assess the impact of organizational cultures on institutions' culture of risk awareness. In general, the awareness of risk is probably stronger in those institutions which have suffered recurrent losses, typically from their non-sovereign loans. It is thus likely that the awareness of credit risk in loan portfolios is higher within the IFC and the EBRD, who regularly suffer loan defaults and writeoffs, than in the IBRD or the ASDB, whose defaults, not to mention writeoffs, historically have been very modest. But developing that awareness will obviously be very important for those MDBs planning to substantially increase their non-sovereign lending. It is unreasonable to expect staff who have spent all or most of their careers making sovereign loans to morph overnight into skilled lenders to the private sector or into successful equity investors.

1. Capital Adequacy Management

The following summarizes the capital adequacy methodologies of the six comparator institutions on an institution-by-institution basis.

a. International Bank for Reconstruction and Development

Under IBRD's Strategic Capital Adequacy Framework adopted in 2008, IBRD's principal risk management tool is its equity-to-loans ratio, which is targeted at a range of 23-27%. This range is derived from the shareholders' equity required to pass IBRD's income-based stress test for nonaccrual shock size, which in turn requires that income grow even under a stress scenario. This permits IBRD's loan portfolio to continue to grow even in a time of financial stress, ensuring that IBRD can be at least not procyclical.

The stress test is based on the performance of IBRD's own portfolio of sovereign loans during the ten years preceding 2008 (since which time portfolio performance has substantially improved). The 23% loans-to-equity ratio is consistent with the average performance over that period; the 27% with the worst-case performance. As a consequence of this methodology, internally-derived probabilities of default are used, which implicitly incorporate IBRD's historical preferred creditor treatment.

IBRD's risk management model currently incorporates only risk from its loan and guarantee portfolios. Other risks are deemed to be minimal as a consequence of the Bank's conservative risk-management policies. A review is currently looking at ways to incorporate non-loan risks into the Bank's risk management framework.

IBRD's equity-to-loans ratio guides the Bank's overall lending capacity and the establishment of its single-borrower limit. For planning purposes, this ratio is projected out ten years, reflecting the long time necessary for loan applications to translate into outstanding loans and for the "levers" aligning capital to shareholder goals to show an impact (i.e., adjustments in new loan pricing).

b. International Finance Corporation

Prior to the adoption of its CAPRI (Capital, Pricing, and Risk) model in 2007, IFC's capital adequacy was calculated using a Basel I-type risk-weighted asset methodology. Under this approach, risk-weighted assets (less specific reserves) were limited to net worth plus general reserves. Weights, which were not very granular, were determined based on the performance of IFC's portfolio from 1957 to 1993.

IFC's CAPRI model uses an economic capital approach conceptually similar to the advanced methodologies implemented under Basel II and updated under Basel III to determine the minimum capital required to cover financial, operational, and "residual" risks. However, it contains some differences to reflect special features and concerns of IFC: in particular, the model estimates total resources required (TRR)—the sum of the economic capital requirements for the different risk types and portfolios—over a three-year (rather than a one-year) period to a confidence level of 99.97% (rather than 99.90%). The result is compared to the "total resources available" (TRA)—IFC's paid-in capital, its retained earnings net of designations and some unrealized gains and losses, and total loan loss reserves. The difference, less a "conservation buffer" of 10% of TRA to absorb short-term fluctuations in TRR and TRA resulting from the volatile nature of IFC's portfolio, is "deployable strategic capital" (DSC) that is available for additional commitments over and above the current portfolio that is deemed by IFC as consistent with maintaining its 'AAA' rating. IFC's model continues to be refined.

While the model was originally developed for capital adequacy purposes, it was envisioned from the outset as having wider utility. It is now being used in the determination of loan pricing, limit setting, and capital allocation.

IFC's "investment portfolio"—its loans and equity investments—accounted for about 90% of TRR at end-March 2012. For calculation purposes, weights are attached to five types of investment assets: short-term finance, senior loans, subordinated loans, quasi equity, and straight equity. These weights, which are based on the historical performance of IFC's investment portfolio dating back to 1957 and are updated annually—a bottom up analysis—are determined using a probability of default/loss given default approach. They reflect periods of financial stress, as well as a "through-the-cycle" approach, which at least limits the pro-cyclicality of IFC's activities. In addition, these numbers are submitted to a variety of stress tests, but the weights have proven to be quite robust for

reasonable stresses. Because IFC uses its own data, the weights also reflect the variety of expected preferred creditor treatment generally afforded IFC loans. The weights attached to these investment assets currently range from 11% (short-term loans) to 70% (straight equity).

IFC's treasury risk, including both credit and market risk, is currently assessed as 1.5% of total treasury exposures. It is recognized that this number can change substantially with market conditions and asset composition, and refining this assessment is on IFC's to-do list.

Since IFC has insufficient experience with operational losses to build a credible distribution, it has opted to base its economic capital for operational losses on a multiple of gross income, in line with Basel II's Basic Indicator and Standardized Approaches. The actual calculation requires adjustments for IFC's business mix and its higher confidence level requirements. These adjustments raise IFC's required capital for operational risk well above that of the Basel II methodology.

While IFC's management and its Board of Directors monitor DSC regularly, it does not have specific ranges for the dollar amount of its DSC or the ratio of DSC to TRA.

IFC had several discussions with S&P and Moody's when its capital adequacy model was being developed, and S&P and reportedly Moody's blessed its approach as supportive of IFC's 'AAA' rating. IFC recognizes that the rating agencies consider factors other than capital, but they believe that the output of this model is their best estimate of the capital required to maintain their 'AAA' rating.

c. European Bank for Reconstruction and Development

Prior to the adoption of its Economic Capital Policy (ECP) in 2010, EBRD managed its capital adequacy principally by ensuring that it remained within the "statutory capital" constraint laid out in the Agreement Establishing the Bank. This constraint required that the sum of total loans, equity investments, and guarantees not exceed total subscribed capital, reserves, and surpluses; in fact, the Bank employed a prudential threshold of 92% for planning purposes. The Bank also ensured that it had in place sufficient risk capital to bear the risks of its investments, as well as other on- and off-balance sheet risks, but these were not formally integrated into a single risk-based model.

EBRD now manages its capital under two constraints: its statutory capital constraint and its ECP. The ECP is primarily a capital planning tool used in the context of three to five year planning estimates, where the composition of future portfolios represent estimates and where an allowance for an economic downturn is incorporated into the risk proxies to ensure that the Bank has the capital capacity to at least avoid being pro-cyclical, aiming to retain capacity to be counter-cyclical.

The Bank's methodology estimates "required economic capital" (REC), equal to the sum of expected and unexpected losses from the Bank's banking and treasury portfolios under a worst-case scenario, as well as operational risk. This is compared to the Bank's

“available economic capital” (AEC), which consists of paid-in share capital (including amounts due under promissory notes of shareholders) and the Bank’s reserves and retained earnings. It does not include callable capital. The methodology employs a 99.99% confidence level over a one-year time horizon. The Bank currently does not “hold back” capital, i.e., operate below its target level of REC, to allow for additional counter-cyclical business. However, it limits the REC/AEC ratio to 90% to cover unidentified risks in terms of model computations and underlying uncertainty in capital planning.

EBRD’s methodology estimates capital requirements for four separate categories of risk: credit risk in its banking book, with that for sovereign loans, non-sovereign loans, guarantees, and equity investments assessed separately; foreign exchange risk in its banking book; treasury risk; and operational risk.

The Bank makes a “prudent assumption” of a loss of 10% on its sovereign loan portfolio, which reflects expected preferred creditor treatment. Capital requirements for non-sovereign loans are based on probabilities of default and loss given default from both internal and external sources. Banking foreign exchange risk derives from two sources: potential foreign exchange risk on currency swaps against defaulted loans in currencies other than euro; and foreign exchange volatility risk on equity investments in currencies other than euro. Treasury risk is calculated using industry-standard software. Finally, operational risk is calculated as 15% of the Bank’s actual positive average gross annual income over the preceding three years, in accord with Basel II’s Basic Indicator Approach (BIA).

d. Asian Development Bank

Prior to the adoption of its current long-term capital adequacy framework in 2008, ASDB’s capital adequacy framework essentially consisted of maintaining a minimum equity to loans ratio of 35%. This ratio was not changed by changes in the creditworthiness of ASDB’s sovereign borrowers nor in the mix of sovereign versus non-sovereign loans (which were then very modest).

In 2008 ASDB adopted an income-based stress-test methodology much like that of the IBRD to determine whether ASDB has sufficient equity to: (1) absorb an income loss due to a non-accrual shock and the remaining risks in its loan and guarantee portfolio; and (2) generate enough income following that non-accrual shock to support growth of outstanding loans and guarantees of 3% per annum over a ten-year period. The resulting metric is a post-shock equity-to-loans ratio (ELR). So long as the path of the projected post-shock ELR is above the minimum ELR required to cover the risk in the loan and guarantee portfolios, ASDB deems itself to be adequately capitalized. The Bank currently uses an ELR of 26% as its key metric for long-term capital adequacy planning purposes, which is the average of the Bank’s historical minimum pre-shock ELRs from about 1993 to 2007, which period included the Asian financial crisis of the late-1990s.

This methodology assumes that the Bank will never have to write off a sovereign loan, but will suffer economic losses from the fact that it does not charge interest on past-due

interest. The non-accrual shock is estimated using a Monte Carlo simulation with a 99.00% confidence level as the main stress scenario; in addition, the Bank also does some structured scenario analyses, under which certain assumptions are imposed on the credit portfolio and/or on the financial projections. Because ASDB does not have a sufficiently long history and lacks sufficient experience with sovereign defaults, it uses the experience of another MDB to estimate probabilities of default, so expected preferred creditor treatment is implicit.

ASDB has very limited experience with non-sovereign defaults. Accordingly, it maps its own internal credit ratings to Moody's 1-year average cumulative issuer-weighted global default rates over the past 25 years to determine probabilities of default.

Central to ASDB's methodology is that it will be able grow its loan portfolio by at least 3% per annum over a ten-year period even in a time of financial stress. It thus promotes at least cyclical neutrality.

The Bank's capital adequacy model is the basis for its Long-Term Capital Adequacy Framework. This guides ASDB's lending programs, its income allocation, and loan pricing reviews.

e. African Development Bank

AFDB's capital adequacy approach has been evolving, with its risk-based capital approach becoming more refined as the Bank moves to an economic capital approach, targeted to become effective later this year.

AFDB currently measures capital adequacy in terms of three metrics: (1) its Risk Capital Utilization Rate (RCUR), which restricts the risk-weighted exposure of the bank from all of its operations to 100% of risk capital; RCUR is periodically subject to stress scenarios, such as a default of the largest borrower or the downgrades of its five largest borrowers; (2) its Debt to Usable Capital (leverage ratio), which restricts gross outstanding debt to 100% of usable capital, i.e., paid-in capital plus reserves plus the callable capital of member countries rated 'AA' or better; and (3) its statutory lending limit (gearing ratio), which limits outstanding commitments to 100% of unimpaired subscribed capital and reserves.

For calculating RCUR, AFDB measures the risk in its sovereign loan portfolio using Moody's idealized probabilities of default, with some adjustments for the Bank's own experience with defaults, reflecting its expected preferred creditor treatment. AFDB also uses Moody's idealized probabilities of default for its non-sovereign loans, combining it with data from the Global Emerging Markets (GEMS) database. Credit risk in the Bank's treasury portfolio is calculated using the Basel II standardized approach, while market risk is assessed by shifting yield curves upward and downward by 100 basis points. Operational risk is assessed using Basel II's Basic Indicator Approach. The results of this risk calculation is adjusted to a three-year time horizon and a 99.99% confidence level.

AFDB uses a threshold approach, rather than a range approach, to assess its capital adequacy. As the projected RCUR looks to be approaching 90%, management proposes a series of options/actions intended to maintain RCUR within limits. These options include reductions of distributions of net income, adjustments in loan pricing, limitations on risk-taking to only the most risk/reward efficient alternatives, and the reduction of the portfolio's growth.

The Bank uses a risk-based capital allocation approach to determine its global lending. The capacity limits for each country are then derived using the risk charges associated with that country. The sustainable level of lending for each country is derived in such a manner as to ensure that the country doesn't exceed its country limit over the planning horizon. Two planning horizons are used in the Bank—a medium-term horizon of five years and a long-term horizon of 10 years.

f. Corporación Andina de Fomento

CAF currently operates subject to three capital-related constraints: (1) its gearing ratio, calculated as the sum of its outstanding loans, equity investments, and guarantees divided by its shareholders' equity. The gearing limit is $\leq 4x$ shareholders' equity; (2) its leverage ratio (which indirectly translates into an approximation of a gearing ratio), calculated as gross debt/shareholders' equity. The limit is $\leq 3.5x$ shareholders' equity; and (3) its Basel II risk-weighted exposure, which is shareholders' equity $\geq 30\%$ risk weighted assets. CAF's risk-weighted asset limit is generally the binding constraint on its lending.

In making its calculations, CAF uses the "standardized approach" of Basel II, using ratings, where available, from the international rating agencies. Where no rating is available, CAF uses the country rating as a proxy, consistent with Basel II methodology. In order to maintain comparability with commercial financial institutions, CAF makes no adjustments for expected preferred creditor treatment in the weights it assigns to sovereign exposure. Off-balance-sheet obligations carry credit conversion factors ranging from 20% to 100%, depending on the nature of the transaction.

CAF is a demand-driven institution, i.e., it discusses with members their desired financing from CAF over a ten-year horizon and uses those desires to help determine its capital needs. It then infers the required contributions of paid-in capital over that ten-year horizon. This method of determining its capital requirements helps explain CAF's long and unparalleled record of frequent contributions of paid-in capital by its shareholders, which is a significant rating strength.

The Bank uses a top-down approach to establishing country exposures and its mix of sovereign and non-sovereign loans. Once it projects its available capital, it can determine the size of the loan portfolio that can be accommodated. Then the programs for its various member countries are determined, with the split between public and private sector lending determined on an annual basis. This split can vary across countries and through time, depending in part on the market access of its borrowing member countries.

As is true of other MDBs, the use of its capital adequacy model impacts only indirectly CAF's ratings from the international rating agencies. However, the 30% equity to risk-weighted assets that CAF uses as a constraint results in capitalization ratios that, however measured, are high compared to those of commercial institutions. While lessening in recent years, the geographic concentration in CAF's loan portfolio holds its ratings below what they might otherwise be based on capitalization ratios alone.

CAF generally operates below its 30% capital-to-risk-weighted assets limit in order to maintain some capacity for unexpected requests for financing. However, it does not have as an explicit policy objective doing counter-cyclical lending. Given CAF's less than 'AAA' rating and lesser financial market access than more highly-rated MDBs, it views stress primarily in terms of its liquidity policy. It targets being able to go for 12 to 18 months without accessing the market.

2. Loan Pricing Methodology

The pricing for sovereign and sovereign-guaranteed assets is transparent for all comparator MDBs. It also tends to be relatively stable in terms of spreads, and typically is not designed to be counter-cyclical, although most MDBs' loan spreads were increased in the aftermath of the start of the global recession. Pricing for non-sovereign loans by its nature is not transparent and is largely market-driven.

a. International Bank for Reconstruction and Development

IBRD's Board of Directors reviews and establishes loan pricing annually. There is no strict methodology for determining charges, but in doing so the Board considers (1) whether loan charges cover lending-related administrative costs over the medium term; (2) the Bank's medium-term financial outlook for income and capital adequacy; and (3) borrowers' cost of financing from the capital markets and the other MDBs. There is no explicit lending capacity or counter-cyclical objective attached to IBRD's loan pricing, nor are there very specific criteria that loan charges must meet.

Historically IBRD charged a relatively high contractual spread, but waived a portion of that spread for members making their payments on time. Since 2007, new conventional loans are charged a front-end fee and a spread, raised to 50 basis points from 30 basis points in 2009. Beginning in 2010, a market risk premium of 10 basis points is charged for loans with an average maturity of up to 15 years, and 15 basis points for loans with an average maturity of more than 15 years. There is no "supervisory fee."

IBRD's loan charges are not explicitly designed to promote counter-cyclical lending. IBRD loans are generally attractively priced, especially for its less creditworthy borrowers. Their attractiveness increases during times of financial stress when the pricing and availability of alternative financings increase, so in that limited sense its lending is counter-cyclical.

IBRD's loan pricing supports its lending capacity and capitalization, since it contributes to the Bank's equity. The general stability in its loan pricing limits the applicability of pricing policy to maintaining competitiveness as market conditions change.

b. International Finance Corporation

Historically, IFC has relied primarily on external market prices and judgmental estimates of risk in individual investments, none of which were sovereign or sovereign-guaranteed. The weight of these two factors varies across countries and across product groups: a more conventional transaction in a more creditworthy country is typically more easily priced than is a more innovative transaction in one of IFC's "frontier" countries.

One of the positive attributes of IFC's CAPRI model is that it provides useful information in the form of a quantitative estimate of expected and unexpected losses in transactions across product lines. It also facilitates the use of the risk-adjusted return on capital metric, which is a more appropriate measure of profitability for a development institution than standard measures of profitability. Finally, it helps staff focus on the risk/reward tradeoff, although this is not necessarily decisive given the overriding importance of IFC's development role.

c. European Bank for Reconstruction and Development

Pricing for EBRD's sovereign loans is the same for all borrowers and has been unchanged since the Bank's inception in 1991: a spread of 1% over libor; an upfront fee of 1%; and a commitment fee of 0.5%. The 1% spread represents the estimated average return required to cover administrative expenses and provisions.

Pricing for EBRD's non-sovereign loans is intended to reflect market pricing for risk, rather than crowding out private financing or subsidizing borrowers. At the same time, it seeks to price through the cycle, which translates operationally into a more active effort to syndicate risk in times of prosperity and avoiding taking undue advantage in a time of financial stress. This is important for the Bank, as it generally seeks to attract commercial banks and other private investors in its cofinancing of its private sector projects. The Bank does not use a pricing model, nor does it have explicit hurdle rates.

d. Asian Development Bank

ASDB reviews its sovereign pricing annually, taking into account the Bank's net income outlook; its capital adequacy outlook; coverage of its administrative costs; and comparability with its peers. Loan charge pricing discussions do not focus on counter-cyclical lending.

The Bank's loan pricing structure for ordinary sovereign loans includes a spread, commitment fees and, effective April 2012, a maturity premium of 10 basis points per annum for loans with an average maturity of 13 to 16 years and 20 basis points per annum for longer maturities. For "legacy loans" with a spread of 60 basis points per annum, there is a waiver of 20 basis points per annum. During 2010-11, the Bank raised

its spread on ordinary sovereign loans to 40 basis points per annum from 20 basis points. The Bank's countercyclical lending—sometimes referred to as “crisis lending”—carries a spread of 200 basis points per annum, a 75 basis point per annum commitment fee, and stand-alone cost pass through pricing reflecting the funding cost at the time of funding of such loans. The Bank does not charge a “supervisory fee.”

ASDB's pricing of non-sovereign loans is supported by a risk-adjusted return on capital pricing tool, but it remains primarily market based. Pricing includes a credit spread to cover the risk level in the individual transaction, a commitment fee, and an upfront fee to cover the costs of originating the loan.

e. African Development Bank

AFDB considers itself to be a partially-self-sustaining financial institution which requires additional capital contributions from time to time. The guiding principles of the Bank's loan charge policies are that loan charges should be reflective of the true cost of funding; should be adequate to cover direct lending-related expenses; must be able to absorb average expected losses over the lifetime of the loan and recover capital costs with due regard to borrowers' financial constraints; must be competitive with comparable institutions or the market while supporting portfolio growth; and must be predictable and transparent. Loan pricing is currently not adjusted to ensure an adequate level of capitalization. It is also not specifically designed to promote counter-cyclical lending.

Sovereign loan pricing for ordinary loans includes a funding margin over the cost of funds (usually Libor, Euribor, or Jibar); a lending spread, which is updated regularly to ensure that the Bank is able to cover its operational expenses (this was increased to 60 basis points from 40 basis points in 2010); and a commitment fee of 20-25 basis points per annum for the difference between scheduled and actual loan disbursements. No supervisory fee is charged. The Bank approved an emergency lending facility in 2009 for short-term public sector loans, which were priced at a spread of 250 basis points over Libor.

The pricing on AFDB's non-sovereign loans is more complicated. It consists of a base rate of Libor for floating rate loans and the corresponding swap rate for fixed-rate loans; a risk premium to reflect credit risk, tenor risk, and concentration risk; an administrative mark-up to reflect the economic contribution to the Bank's income and costs associated with the processing and administration of the loan; and fees, usually taken up front at the time of signing, consisting of appraisal and front-end fees; and a commitment fee. Finally, there is a “flexible margin,” which provides a formal mechanism for adjusting pricing for commercial- and market-driven considerations, which can be negative or positive. The Bank does not charge a supervisory fee for non-sovereign loans.

f. Corporación Andina de Fomento

CAF's loan pricing methodology is not tied directly to its capital position nor is it designed to be countercyclical. There is also not an elaborate model to determine appropriate pricing on sovereign and private-sector loans, and the same pricing for

sovereign loans may be retained for several years. Changes when made are usually small. While there is not an explicit target coverage ratio, CAF's lending margins over six-month Libor are intended to cover its funding spread, provisions for losses, and administrative expenses, leaving a small but positive profit under any circumstances.

Like other MDBs, CAF charges all sovereign borrowers the same spread over six-month Libor, which does not vary during the life of the loan, with the benchmark for returns from sovereign lending being the return on 10-year U.S. treasuries. In addition to a spread, for sovereign loans CAF charges a flat upfront fee, a commitment fee on the undisbursed portion of committed loans, and a prepayment fee (when a sovereign prepays a loan). There is also a risk-premium fee for longer-term financings. Non-sovereign loans are charged a market-related spread, an upfront fee, and a commitment fee, with other fees possible depending on the details of the loan.

CAF does not see itself as competing directly in its sovereign lending with other MDBs, given its nature as a cooperative lending institution. Its sovereign loan pricing is typically higher, reflecting in part its higher cost of funding. However, it offers offsetting advantages for its sovereign borrowers that make it an attractive source of funding for some transactions.

3. Risk Management Framework

There appear to be a variety of different risk management structures employed by comparator MDBs, and it is difficult to assess the impact of organizational structures on an institution's culture of risk awareness. In general, the awareness of risk is probably stronger in those institutions which have suffered recurrent losses, typically from non-sovereign lending. It is thus likely that the awareness of credit risk in loan portfolios is higher within the IFC and the EBRD, who regularly suffer loan defaults and writeoffs, than in the IBRD or the ASDB, whose defaults, not to mention writeoffs, historically have been very modest. Developing that awareness will obviously be very important for those MDBs planning to substantially increase their non-sovereign lending. It is unreasonable to expect staff who have spent all or most of their careers making sovereign loans to morph overnight into skilled lenders to the private sector or into successful equity investors.

a. International Bank for Reconstruction and Development

IBRD's Chief Risk Officer (CRO) reports directly to the Chief Financial Officer (CFO). The CRO is responsible for assessing risks; benchmarking existing risk management practices against major financial institutions; ensuring consistency of risk management activities with best practice; and considering unique risks that are specific to MDBs. The CFO chairs the Finance Committee, which reviews, evaluates, and decides on matters related to IBRD's finances to ensure that these are aligned with corporate financial and risk tolerance objectives set by the Executive Directors. There are four subcommittees that provide technical expertise and guidance on strategy, policy, risk management, and new initiatives issues presented to the Finance Committee. These four subcommittees are

the Strategy, Performance, and Risk Subcommittee; the Finance Initiatives Subcommittee; the Credit Risk Committee; and the Operational Risk Subcommittee.

In addition to these subcommittees, the Corporate Finance Department, the Market and Counterparty Risk Department, and the Credit risk Department play key roles in financial risk management. All three departments are independent from IBRD's operational business units and report directly to the Vice-President, Corporate Finance and risk Management.

The Bank's risk management approach reflects best practice, particularly with respect to their being an avenue for reviewing and assessing risk outside of the business units.

IBRD is unique among MDBs, since it lends only to sovereign borrowers or to others with sovereign guarantees. There may thus be less of a risk awareness culture than at some other MDBs, despite the best efforts of management.

b. International Finance Corporation

IFC's senior management has defined a comprehensive enterprise risk management framework within which risks are continuously identified, measured, controlled, monitored, and analyzed. IFC manages all risks through four Management Committees: the Corporate Risk Committee, the Corporate Equity Committee, the Corporate Operations Committee, and the People and Leadership Committee. The Corporate Risk committee reviews all risk policies and sets risk standards for the Corporation and receives regular reports on different aspects of risk exposure and mitigation.

The Risk Management, Financial Reporting, and Corporate Strategy Vice Presidency monitors compliance with these policies. There are five departments under this vice presidency: (1) the Integrated Risk Management Department, which develops and maintains the IFC's financial policy framework, including risk policies, limits and methodologies for exposure measurement and capital allocation for IFC products; (2) the Investment and Credit Risk Department, which reviews the credit assessments undertaken by transaction teams and assists investment departments in structuring investments, assessing the risk/reward balance, and structuring IFC compensation; (3) the Corporate Portfolio Management Department, which analyzes portfolio risks across IFC's equity and debt portfolio and reports to Management; (4) the Special Operations Department, which is responsible for resolution of problems and special issues in IFC's investment portfolio and assisting in the distressed business; and (5) the Accounting and Financial Operations Department, which manages the budget cycle, provides financial reports, manages operational risk associated with accounting and valuation of operations, and monitors information quality.

IFC has lent without sovereign guarantees since its establishment in 1957 and also makes equity investments. Accordingly, the culture of risk awareness is deep-seated in the institution.

c. European Bank for Reconstruction and Development

The independent identification, measurement, monitoring, and mitigation of all risks incurred by the Bank in both its banking and treasury operations are the overall responsibility of the Vice President Risk. The First Vice President Banking chairs the Operations Committee, which consists of senior managers of the Bank. This committee reviews all banking operations prior to their submission to the Board. The Vice President Finance chairs the Treasury Exposure Committee, which also consists of senior managers of the Bank. This committee is responsible for reviewing and monitoring the implementation of the Treasury and Treasury Risk Management Authority and related guidelines.

EBRD predominantly lends to non-sovereign borrowers, as well as makes substantial equity investments. This focus has contributed to a culture of risk awareness.

d. Asian Development Bank

In 2005 ASDB established its Office of Risk Management (ORM), which centralized the Bank's financial and operational risk (other risks are managed on a departmental basis). ORM reports to the President through the Managing Director General, who is independent of the Bank's operational areas. ORM has five key organs: credit risk assessment division; credit portfolio monitoring division; market and treasury risk unit; operational risk unit; and policy and systems unit.

ASDB's sovereign loan portfolio historically has performed extremely well, while its non-sovereign loan portfolio has been very small as well as performing well. In addition, since the late 1990's most countries in Asia have performed relatively well. A strong culture of risk awareness would probably be difficult to build in this lending environment.

e. African Development Bank

The most senior management forum on finance and risk management is the Bank's Asset and Liability Management Committee (ALCO), which is chaired by the Vice President for Finance. ALCO meets regularly to review regular and ad-hoc finance and risk management reports and projections, approves strategies to adjust the balance sheet, and confirms country and project credit risk ratings and the associated incurred loss estimates. ALCO is supported by standing working groups that report on specific issues, including country risk, non-sovereign credit risk, interest rate risk, currency risk, operational risk, financial projections, and financial products and services. Day-to-day operational responsibility for implementing the Bank's financial and risk management policies and guidelines is delegated to the appropriate business units. The Financial Management Department is responsible for monitoring the day-to-day compliance with those policies and guidelines.

AFDB has a strong culture of risk awareness, given its long history of difficulties with its sovereign loan portfolio. They are being very careful as they ramp up their non-sovereign lending.

f. Corporación Andina de Fomento

The main administrative body is the controller's office, which reports directly to the executive president and the audit committee of the board of directors and oversees all risks—credit, liquidity, foreign exchange, and interest rate risk. There are risk units that are involved in the credit approval process; in the credit administration process, once loans have been disbursed; and in treasury, where they have the power to stop transactions that fail to meet guidelines.

In general, CAF appears to have a strong credit culture. In part, this may be attributable to the fact that for many years a significant portion of CAF's lending has been to the private sector, which has experienced some difficult years.

Annex B

S&P Rating Criteria: Prospects for IDB to Maintaining its AAA Rating

Standard & Poor's (S&P) released its updated criteria "Multilateral Lending Institutions And Other Supranational Institutions Ratings Methodology" in Dec 2012.

The new criteria is much more prescriptive than the former criteria, with quantitative factors, particularly capital adequacy, addressed much more rigorously than in the past. However, there remains considerable scope for qualitative factors to influence ratings, and these qualitative factors are generally positive for IDB.

Under S&P's new criteria, the Issuer Credit Rating (ICR) – the rating S&P would assign to an MDB's plain vanilla bond issues – is a function of two sets of factors: S&P's calculation of an MDB's Stand-Alone Credit Profile (SACP); and its assessment of the Extraordinary Shareholder Support that an MDB might enjoy in a time of stress.

1. S&P's Stand-Alone Credit Profile Assessment

S&P's SACP criteria was explicitly modeled after the updated financial institutions criteria that was released in November 2011. It reflects what S&P calls an MDB's Business Profile and its Financial Profile, which are combined in the matrix shown in table 1. This says, for instance, that an "Extremely Strong" Business Profile and a "Very Strong" Financial Profile are consistent with an 'aaa' SACP.

Table 1

Determining An MLI's SACP							
--Business profile--	--Financial profile--						
	Extremely strong	Very strong	Strong	Adequate	Moderate	Weak	Very weak
Extremely strong	aaa	aaa/aa+	aa+/aa	aa/aa-	a+/a	a-/bbb+	bbb/bbb-
Very strong	aa+/aa+	aa+/aa	aa/aa-	a+/a	a/a-	bbb+/bbb	bb+/bb
Strong	aa+/aa	aa/aa-	a+/a	a/a-	bbb+/bbb	bbb/bbb-	bb/bb-
Adequate	aa/aa-	a+/a	a/a-	bbb+/bbb	bbb/bbb-	bb+/bb	b+/b
Moderate	a+/a	a/a-	bbb+/bbb	bbb/bbb-	bb+/bb	bb-/b+	b/b-
Weak	a-/bbb+	bbb+/bbb	bbb/bbb-	bb+/bb	bb/bb-	b+/b/b-	ccc+/ccc/ccc-
Very weak	bbb+/bbb	bbb/bbb-	bb+/bb	bb/bb-	b+/b/b-	ccc+/ccc/ccc-	cc

a. S&P's Business Profile Assessment

The anchor to the S&P's assessment of an MDB's Business Profile is its view of the Policy Importance and the Governance and Management Expertise of the MDB. Its criteria includes a listing of the characteristics that drive S&P's assessment of the Policy Importance and Governance and Management Expertise of an MDB, which are shown in Table 2 and 3.

Table 2

Policy Importance Assessment					
	Very strong	Strong	Adequate	Moderate	Weak
Role	Role is not or cannot be readily fulfilled by another private or domestic public institution, and we expect this role to be maintained.	Role is or can be partially fulfilled by a private or another domestic public institution, or strong role is diminishing.	Diminishing role that is or can be partially fulfilled by another private or domestic public institution.	An increasing part of the MLI's activity is fulfilled by private entities.	A large part of the MLI's activity is fulfilled by private entities.
Public policy mandate	The MLI has a track record of more than two decades of fulfilling its public policy mandate throughout credit cycles, and we expect this to continue. Track record of increases and timely payments of capital subscriptions by shareholders when needed to support its public policy mandate, and we expect this to continue.	Shorter track record of fulfilling its public policy mandate. Its policy mandate is less important, for instance because of the limited geographical scope of its activities. Track record of increases and timely payments of capital subscriptions by shareholders when needed to support its public policy mandate, and we expect this to continue.	Shorter track record of fulfilling its public policy mandate. Its policy mandate is less important than peers in the "strong" category. The payment of significant scheduled capital subscriptions has not been made on schedule (within 90 days) by shareholders.	Weakening ability to fulfill its public policy mandate.	The MLI is expected not to be able in the future to fulfill its public policy mandate through the credit cycle.
Strength and stability of the relationship with shareholders	The MLI was established by treaty. No major shareholder has withdrawn from the MLI in the recent past or is expected to do so in the medium term. The MLI's earnings are exempt from corporate income tax.	The MLI was established by treaty. No major shareholder has withdrawn from the MLI in the recent past or is expected to do so in the medium term. The MLI's earnings are exempt from corporate income tax.	Shareholders' support is weakening (e.g., a major shareholder recently withdrew from the MLI). The MLI's earnings are exempt from corporate income tax.	The MLI was not established by treaty. Shareholders' support is uneven.	The MLI was not established by treaty. Shareholders' support is weak and uncertain. The MLI's earnings are not exempt from corporate income tax.
PCT and preferential treatment	The MLI has historically benefited from PCT for its government lending, and we expect this to remain so in the future.	The MLI has historically benefited from PCT for its government lending, and we expect this to remain so in the future.	The MLI has historically benefited from PCT for its government lending and (where relevant) benefited from preferential treatment.	Less certainty or short track record in borrowers' affording an MLI PCT and (where relevant) preferential treatment.	The PCT and (where relevant) preferential treatment is uncertain.

By any reasonable reading, the IDB would warrant a "Very Strong" Policy Importance assessment.

S&P's criteria includes a listing of the characteristics that drive S&P's assessment of the Governance and Management Expertise of an MDB, which are shown in Table 3.

Table 3

Governance And Management Expertise Assessment			
	Strong	Satisfactory	Fair or weak*
Factors generally seen in each category	<p>–Transparent, prudent, and independent governance and management, generally characterized by:</p> <p>–Diverse and balanced composition of government shareholders (with usually five or more shareholders with more than token stakes).</p> <p>–Well-established governance standards with a clear mandate.</p> <p>–No material private-sector shareholding.</p> <p>–Ability to implement strategic plans and achieve financial and operational goals in fulfilling its public policy role.</p> <p>–Management has considerable expertise, experience, and a track record of success in operating all of its major lines of business.</p> <p>–Ability to withstand loss of key personnel without significant disruption to operations in each of its significant business units.</p> <p>–High ranking in governance (see paragraph 30) is reflective of strong MLI management's governance standards.</p> <p>–The institution employs superior financial and risk management policies in relation to its business activities.</p> <p>–Shareholders allow most of the MLI's earnings to be consistently retained to provide for a solid growth.</p>	<p>–MLIs other than "strong," "fair," and "weak."</p>	<p>–The MLI is predominantly controlled by one or two shareholders.</p> <p>–Borrowing member countries have control and a significant influence over decision-making.</p> <p>–The strategic planning process is limited or plans are superficial.</p> <p>–Management is often unable to convert strategic decisions into constructive action or often fails to achieve its financial and operational goals.</p> <p>–The MLI relies on one or a small number of managers. The loss of key personnel would seriously affect the organization's operations, or management lacks the expertise and experience, and the MLI often deviates significantly from its plan.</p> <p>–Risks to governance standards stemming from low governance ranking (see paragraph 30).</p> <p>–The institution employs inferior financial and risk management policies relative to its operations.</p> <p>–Earning distributions (grants, transfers) lead to capital base erosion.</p>

*Selection of "fair" versus "weak" depends on magnitude of risks defined in this category and its prevalence for the given institution.

By any reasonable reading, the IDB would warrant a "Strong" Governance and Management Expertise assessment. Referring back to table 1, the combination of a "Very Strong" Policy Importance assessment and a "Strong" Governance and Management Expertise assessment would result in an "Extremely Strong" Business Profile.

b. S&P's Financial Profile Assessment

There are two key factors in S&P's Financial Profile Assessment. The first and most important is Capital and Earnings; the second, is Funding and Liquidity.

The most important difference between the new criteria and the former criteria is the introduction of S&P's proprietary "risk-adjusted capital" (RAC) framework, which anchors MDBs' Capital and Earnings assessments. The methodology used in calculating RAC ratios for MDBs is identical to that used for banks. In principle, this was a big improvement: the focus of the former criteria was merely on the sum of loans, equity investments, and guarantees relative to capital (calculated with and without 'AAA' callable capital), although this ratio was supplemented by an "index of credit quality of country exposure," which took into account the ratings of the countries in which MDBs had their exposures. By contrast, S&P's RAC ratio calculation weights various asset classes depending on their ratings.

Table 4 shows S&P's assessment of capital and earnings associated with different ranges of RAC ratios.

Table 4. Assessing Capital and Earnings	
Assessment	RAC ratio
Extremely strong	Above 23%
Very strong	Above 15% and up to 23%
Strong	Above 10% and up to 15%
Adequate	Above 7% and up to 10%
Moderate	Above 5% and up to 7%
Weak	Above 3% and up to 5%
Very weak	Lower than 3%

In borderline cases, the RAC ratio may be elevated by one category by high quality capital and earnings—for instance, from “Very Strong” to “Extremely Strong.” IDB would likely receive that elevation if its RAC ratio were considered borderline.

A more important adjustment for IDB is that for “Risk Position,” which in S&P's language “serves to refine our view of an institution's actual and specific risks beyond the standard assumptions in the Capital and Earnings analysis” and can improve the capital and earnings score by one category, leave it unchanged, or worsen by one category or more, depending on the magnitude of such risks. The assessment for Risk Position is shown in Table 5.

Table 5

Assessing An MLI's Financial Profile: Risk Position		
Assessment	Effect on the MLI's capital adequacy	RAC after adjustment
Very positive	Improves the capital and earnings assessment in table 6 by two categories (e.g., "strong" becomes "extremely strong")	RAC after adjustment scored by table 6 falls two categories or more above the unadjusted RAC
Positive	Improves the capital and earnings assessment in table 6 by one category (e.g., "strong" becomes "very strong")	RAC after adjustment scored by table 6 falls one category above the unadjusted RAC
Neutral	No effect on the capital and earnings assessment in table 6	RAC after adjustment scored by table 6 falls in the same category as the unadjusted RAC
Negative	Lowers the capital and earnings assessment in table 6 by one category (e.g., "strong" becomes "adequate")	RAC after adjustment scored by table 6 falls one category below the unadjusted RAC
Very negative	Lowers the capital and earnings assessment in table 6 by two categories (e.g., "strong" becomes "moderate")	RAC after adjustment scored by table 6 falls two categories below the unadjusted RAC
Extremely negative	Lowers the capital and earnings assessment in table 6 by three categories or more	RAC after adjustment scored by table 6 falls three categories or more below the unadjusted RAC
--Adjustments--		
Positive adjustments		Negative adjustments
--Positive loan performance, loss experience, and risk management compared with the MLI sector (see paragraphs 49-50) can improve the risk position by one category.		--Negative loan performance, loss experience, and risk management compared with the MLI sector (see paragraphs 49-50) can worsen the risk position by one category.
		-- Material risks not covered by the RACF (see paragraphs 51-52) can worsen the risk position by one or more categories.

IDB Risk Position assessment primarily takes into account the RAC after diversification and concentration and PCT. The adjustments for industry diversification and geographic concentration can cause material reductions in many MDBs' RAC ratios—for instance, S&P's criteria piece notes that the RAC ratio for the MDB sector was 52% before the adjustments for diversification and concentration, but 24% after. This presumably reflects in part sovereign exposures being entered into the model by country instead of by individual loan. Qualitative factors pertaining to the Risk Position, which are relevant to IDB's credit rating, is the evaluation of Loss Experience and Risk Management. S&P evaluates loan performance by taking into account past due loans to a soft window of an affiliate or debt forgiveness effected off balance sheet. IDB's past debt relief initiative could essentially hurt its rating.

MDBs' Capital and Earnings assessment can be modified by S&P's assessment of their "Funding and Liquidity." Their interaction and the effects on S&P's assessment of Capital Adequacy is shown in table 6.

Table 6

Financial Profile							
--Funding and liquidity--	--Capital adequacy--						
	Extremely strong	Very strong	Strong	Adequate	Moderate	Weak	Very weak
Very strong	Extremely strong	Extremely strong	Very strong	Strong	Adequate	Moderate	Weak
Strong	Extremely strong	Very strong	Strong	Adequate	Moderate	Weak	Very weak
Adequate	Very strong	Strong	Adequate	Moderate	Weak	Very weak	Very weak
Moderate	Strong	Adequate	Moderate	Weak	Very weak	Very weak	Very weak
Weak	Moderate	Moderate	Weak	Very weak	Very weak	Very weak	Very weak
Very weak	Weak	Weak	Very weak	Very weak	Very weak	Very weak	Very weak

The elements in S&P's assessment of an MDB's funding are summarized in Table 7 below.

Assessing An MLI's Financial Profile: Funding	
Funding assessment	Characteristics
Positive	The MLI has established and substantial market access that significantly exceeds its liquidity needs, as informed by factors such as: --An MLI is a regular benchmark issuer as needed to fund its activities; --No overreliance on a single market; --No expected material deterioration in the MLI's funding conditions, which could result from factors such as a significant lowering of its shareholders' ratings or a questioning of its policy role; and --The MLI has a conservative funding profile, with cumulative assets exceeding consistently cumulative debt for maturities up to one year and no significant gap for five years.
Neutral	Other MLIs
Negative	The MLI meets at least one of the three factors below: 1) Expected material deterioration in the MLI's funding conditions. 2) Limited access to external sources of liquidity or inadequate available market access relative to current or future funding needs as reflected by any of the following factors:

Assessing An MLI's Financial Profile: Funding (cont.)	
	–The MLI is an infrequent issuer,
	–Its issues are of limited size, or
	–It relies predominantly on bank funding,
	or
	3) A vulnerable funding profile, as reflected by any of the following factors:
	–Significant reliance on short-term liabilities,
	–Large funding gap, or
	–A marginal cost of funds in excess of marginal yield on earning assets.

IDB seems likely to have a Positive Funding Assessment given these characteristics.

Table 8 lays out the characteristics of S&P's Liquidity Assessment.

Assessing An MLI's Financial Profile: Liquidity	
Assessment	Characteristics
Very strong	All the characteristics below apply: –The MLI can consistently maintain its scheduled loan disbursements to its borrowing members without access to market funding in the next 12 months, under stressed market and economic conditions and without withdrawing principal resources from borrowing members. –There are no unusual or large liquidity needs in the next 12-24 months, resulting, for instance, from a significant ramp-up expected in the disbursement of committed loans or from material or easily identified contingent liabilities. –There are no financial ratio covenants or rating triggers on material facilities that would result in liquidity strain.
Strong	–The same characteristics as for "very strong" apply, except that the MLI would likely need to reduce moderately the scheduled loan disbursements to its borrowing members under such circumstances.
Adequate	All the conditions below apply: –The MLI can consistently maintain its scheduled loan disbursements to its borrowing members without access to market funding in the next six months, under stressed market and economic conditions, and without withdrawing principal resources from borrowing members. However, under such circumstances, it may have to reduce significantly the scheduled loan disbursements in the following six months in order to ensure full coverage of its liabilities. –There are no unusual or large liquidity needs in the next 12-24 months, resulting for instance from a significant ramp-up expected in the disbursement of committed loans or from material or easily identified contingent liabilities. –There are no financial-ratio covenants, or rating triggers, on material facilities that would result in liquidity strain.
Moderate	Any of the conditions below apply: –The MLI can consistently survive no access to market funding in the next three months, under stressed market and economic conditions, and without withdrawing principal resources from borrowing members, but it may have to reduce significantly its scheduled loan disbursements under such circumstances. –An expected increase in liquidity needs in the next 12-24 months due, for instance, to a significant ramp-up expected in the disbursement of committed loans or to the materialization of important contingent liabilities. –Covenants or triggers are present that, if violated, could result in liquidity strain or cancellation of existing facilities, thereby limiting the MLI's ability to meet the conditions for a higher liquidity score.
Weak	Any of the conditions below apply: –The MLI can survive no access to market funding in the next month, but it may have to reduce significantly its scheduled loan disbursements under such circumstances. –Covenants or triggers are present that, if violated, could result in liquidity strain or cancellation of existing facilities, thereby limiting the MLI's ability to meet the conditions for a higher liquidity score.
Very weak	The MLI's access to market funding is under significant pressure. –The MLI may not be able to meet its next month's financial obligations. –Covenants or triggers are present that, if violated, could result in liquidity strain or cancellation of existing facilities, thereby limiting the MLI's ability to meet the conditions for a higher liquidity score.

On the basis of these descriptors, it is likely that IDB would receive a Very Strong liquidity assessment.

Referring back to table 7, and assuming that IDB's Funding Assessment is likely to be Positive and that IDB's Liquidity Assessment is likely to be Very Strong, IDB's Capital Adequacy Assessment is likely to be increased by one notch, or at absolutely worst no notches.

Accordingly, IDB's Financial Profile seems highly likely to be assessed as "Extremely Strong." Keeping in mind that IDB's Business Profile is highly likely to be classified as Extremely Strong, and certainly not less than Very Strong, IDB's SACP seems highly likely to be classified as 'aaa.' This is before any consideration is given to shareholders support.

2. Shareholder Support

S&P's draft updated criteria states that extraordinary shareholder support "is mostly expected to come in the form of a disbursement (sic) of callable capital." It says that S&P would consider that a shareholder would be willing and able to make a payment on callable capital when the following conditions are met:

- "There is a document approved by the MDB's Board of Governors declaring that a capital call will be made if management opines that a call is necessary to avoid a default and describing the process by which that MDB would make a capital call."
- "Standard & Poor's believes that the shareholders are able to make the payment of capital when called. This view is informed by the legal and administrative processes required for the shareholder to make such payment shortly after the capital call."
- "Standard & Poor's believes that the shareholders are willing to make the payment of capital when called. This view is informed by the shareholders' record in increasing the MDB's capital when needed to support its public policy role or its growing activity, and their record in paying on schedule the paid-in capital for general capital increases. This assessment is not limited to the specific MDB, but extends to shareholders' record in promptly paying capital subscriptions to other MDBs for which they are members. In cases of failure of shareholders to make their payments of capital subscriptions, or repeated arrears on capital subscriptions, we would consider their willingness to make payment on callable capital as low. Conversely, recent increases in paid-in capital by shareholders would affect positively our assessment of shareholders' willingness to support the MDB."

When these three conditions are met, S&P draft revised criteria proposes reflecting a shareholder's expected support by recalculating the RAC ratio, adding to balance sheet capital the callable capital from shareholders with foreign currency ratings equal to or higher than the MDB's ICR resulting from the recalculated RAC ratio.

At year-end 2011, IDB's balance-sheet capital, before the minor adjustments S&P makes, was US\$19.8 billion. At end-August 2012, the callable capital from 'AAA' rated non-borrowing members, including temporary callable capital of US\$4.04 billion, was US\$12.2 billion. If all of this callable capital were eligible for inclusion in the RAC ratio calculation, it would increase the "capital" by nearly 62%; if only the permanent callable capital were deemed eligible, this would increase the capital by more than 40%. With IDB's SACP already highly likely to be in the 'aaa' range, receiving credit for 'AAA'

callable capital means IDB would have substantial room to increase its lending while retaining its 'AAA' rating from S&P.

It should be emphasized, however, that for this callable capital to be counted in the RAC ratio, it would be necessary for IDB's Board of Governors to formally declare that callable capital will in fact be called if necessary. In the past it was simply assumed that such a call would be made, in the highly unlikely event that it were necessary. However, multilateral agreements among governments have been becoming more formal and legalistic. Examples with which S&P is familiar include International Finance Facility for Immunisation (IFFIm), the European Financial Stability Facility, and the European Stability Mechanism. As a consequence, by insisting on some tightening of the documentation for callable capital, S&P is bringing the treatment of MDBs closer to that of other more recent multilateral arrangements.

Annex C

Fitch's Revised MDB Rating Criteria

During 2012 Fitch Ratings released updated criteria on rating multilateral development banks (MDBs). Like S&P's draft revised criteria (see Annex II), it provides improved guidance on how it proposes to go about assigning its ratings. As was the case with its earlier criteria, Fitch's updated criteria does not permit an MDB to definitively determine the rating it will receive. However, it is worthwhile noting that the Fitch criteria piece says that *"there will not be any rating changes related to this revised criteria."*

Fitch's MDB new criteria introduces a Scoring Framework to quantify its rating analysis. The Scoring Framework includes variables that are identified by Fitch as the main rating factors. However, the results of this scoring are supplemented by other factors, and ratings assigned may differ from those indicated by the scorecard.

Two broad factors are incorporated in Fitch's scoring framework: support from shareholders; and "intrinsic" factors. Some of these factors are quantitative and some are qualitative. Fitch details the factors that determine how its quantitative scores are determined.

1. Support from shareholders:

In Fitch's Scoring Framework, the "support" score is measured by a weighted average of five different measures, four of them quantitative and one qualitative (Table 1).

Table 1. Support Score Variables	
Variable	Weight (%)
Average rating of shareholders	20
Average rating of key shareholders	20
Share of callable capital from shareholders rated AA- and above (%)	20
Callable capital from shareholders rated AA- and above/debt outstanding (%)	20
Importance of MDB for member countries (qualitative assessment)	20
Total	100

It is important to note that only callable capital from shareholders with ratings of 'AA-' and above figure into the support scoring; and that this callable capital accounts for only 40% of the support rating.

2. Intrinsic factors

Intrinsic factors reflect the solvency, liquidity, and credit, market, and operational risks of the MDB. They are measured and weighted as follows (Table 2):

Table 2. Intrinsic Rating Scores and Variables		
Sub-score	Variables	Weight (%)
Capitalization	Shareholders' equity/total assets + guarantees (%)	15.0
	Outstanding debt/shareholders' equity (%)	12.5
	Paid-in capital/subscribed capital	3.5
Credit risk	Average rating on loans and guarantees	10.0
	Impaired loans/gross loans (%)	5.0
	Share of liquid assets rated AA- and higher (%)	2.5
	Non-sovereign exposure/total exposure	1.5
	Equity participations/loans and equity participations	1.0
Concentration risk	Five largest single exposures/gross loans (%)	5.0
Liquidity risk	Liquid assets/short-term debt (%)	12.5
Profitability	Net income/shareholders' equity (%)	5.0
Qualitative assessments, of which:		26.5
Risk management policies		10.0
Market risk		5.0
Operational risk		5.0
Strategy and management		5.0
Liquidity mitigants		1.5

With respect to capitalization, Fitch's updated criteria states that *"the ratio of usable capital (equity plus callable capital from shareholders rated AA- and above) to required capital (expected losses on loans, equity participations, treasury assets and off-balance sheet operations) has long been considered a key measure by Fitch... However, the agency has become increasingly concerned by the much greater resort in recent capital increases to callable rather than paid-in capital... The revised methodology, while not dismissing the importance of the ratio of usable capital to required capital, which will still be computed and published by Fitch, places increased weight on capital ratios based on paid-in capital, and in particular the ratio of equity to total assets and guarantees."* It should also be noted that callable capital enters into Fitch's intrinsic scores only implicitly, in the ratio of paid-in to subscribed capital, and here it is a negative factor – the ratio of paid-in to subscribed capital is higher (better) the smaller the component of callable capital.

Fitch also provides a list of factors that enter into its quantitative scoring. These are presented in Table 3 below.

Table 3. Qualitative variable and criteria	
	Description
Relative size of the institution	Size of the institution relative to the economy of the region of operations and shareholders
Reputational risk	Degree of visibility of the bank and reputational damage in case of default
Financing of the region	Amount of financing extended to member countries relative to their needs
History of support	Size of capital increases or other means of financial support from shareholders' delays or refusal to participate in a capital call
Diversification of shareholder base	Number of countries holding the capital and degree of correlation between their economies.
Risk management policies	
Quality of prudential framework	Liquidity and capitalization thresholds, minimum ratings on treasury assets and derivatives, concentration and lending limits, and other risk management guidelines
Organization of risk management	Degree of independence and overall quality of the risk management team
Market risk	
Exposure to interest rate risk	Matching of assets and liabilities on interest rates (after swaps)
Exposure to foreign exchange risk	Matching of assets and liabilities on exchange rates (after hedging)
Quality of hedging instruments	Use of derivatives and other asset and liability management tools
Track record on market risks	History of losses from market activities
Quality of market risk management	Market risk management and organization
Operational risk	
Legal/governance risk	Risk associated with legal issues and governance problems
Political environment in country of head office	Risk of political turmoil in the country hosting the head office
Exposure to and management of operational risk	Risk associated with human or technical deficiencies
Strategy and management	
Management quality and credibility	Past experience and track record of senior management
Growth potential	Potential for growth and risk of targeted sector and geographical areas
Capacity to generate a balanced growth	Ability of management to grow the activity without deteriorating solvency
Liquidity risk mitigants	
Access to refinancing tools	Access to backup credit lines or central bank refinancing window
Maturity of overall operations	Average duration of lending and borrowing operations; average maturity of treasury assets

This is, in principle, a comprehensive list of the factors that Fitch takes into account in assigning its ratings to MDBs. However, their criteria does not detail how the support from shareholders is combined with the intrinsic factors in order to determine an overall credit rating. However, it is clear that callable capital is now providing less support for an MDB's rating than it did in the past.

Annex D

How the Support to an MDB's Rating Given By Callable Capital is Diminishing

During 2012 FitchRatings (Fitch) released its updated methodology “Rating Multilateral Development Banks” (MDBs), and Standard & Poor’s (S&P) released for comment a draft of its “Multilateral Lending Institutions And Other Supranational Institutions Rating Methodology.” Moody’s is reportedly preparing a similar document, with a target publication target of year-end 2012.

Both of these documents take a more skeptical view than previously of callable capital and the role it plays in their ratings of multilateral lending institutions (MDBs). At the same time, however, Fitch says that “there will not be any ratings changes related to this revised criteria,” while S&P says that “we expect few changes to existing MDB or other supranational institution ratings. Based on this proposal, the rating on a couple of MDBs could be increased by one or two notches, while the rating on a few other MDBs could be lowered, reflecting the greater weight given to the MDB’s public policy role, its capitalization level, and the concentration in its loan portfolio.”

Nonetheless, it is important to understand the revised attitude toward callable capital evidenced by the rating agencies.

1. Fitch

a. 2010 Criteria

In its “Sector-Specific Criteria Report” published in 2010, Fitch says that “supranationals’ credit quality derives first and foremost from the support of member states. Support is a key factor in all supranational ratings but varies from being of paramount importance for supranational administrative bodies and highly rated MDBs to somewhat less important for weaker MDBs, where more traditional bank rating factors attract greater weight.” Fitch’s 2010 criteria also says “in Fitch’s approach, the rating of the bank should not, as a general rule, be lower than that of the weighted average rating of the reference shareholders.”

Fitch’s 2010 criteria goes on to say that “intrinsic factors”—“the more traditional factors commonly used in the rating of financial institutions, including capital adequacy, asset quality, concentration, liquidity, leverage, market risks and risk management policies”—are also analyzed.” In Fitch’s opinion, “capital adequacy is the main intrinsic factor for an MDB.”

Capital adequacy as defined by Fitch in its 2010 criteria is measured by the ratio of “usable capital” to “required capital.” Usable capital is defined in the 2010 criteria as being equal to the sum of equity, callable capital from non-borrowing investment grade rated countries, and callable capital from borrowing countries rated at least ‘AA-’.

Thus its 2010 criteria, callable capital enters into Fitch’s ratings of MDBs in two ways: as a factor of “paramount importance” for highly rated MDBs per se; and as an important—

in fact, in some cases an overriding element, given the ratio of eligible callable capital to shareholders' equity—in determining an MDB's capital adequacy, the main intrinsic factor for rating an MDB.

It is not clear from Fitch's 2010 criteria how member support and intrinsic factors are combined to determine a rating. Moreover, Fitch's rationale for treating "support" in the form of callable capital as the first and foremost factor in determining an MDB's credit quality was always (and remains) curious, since balance sheet capital is by definition ready and available, without any capital call having to be made or shareholders having to go through whatever political processes is necessary for a capital call to actually be met. Moreover, the calculation of usable capital, which in the 2010 criteria could include the callable capital of even 'BBB-' rated member countries, implicitly treated a commitment to provide callable capital by a 'BBB-' rated country as equivalent to balance sheet capital. This was surely a generous attribution of value to a BBB- obligation.

b. 2012 Criteria

Fitch's 2012 updated criteria again states that MDBs' "ratings rely on two broad factors: support from member countries and shareholders and intrinsic factors." It also continues to say that "the weighted average rating of shareholders provides a good indicator of the overall quality of support..." and "as a general rule, the rating of an MDB is not lower than that of the weighted average rating of its key shareholders.." However, it adds to this sentence "except if Fitch has doubts about the willingness of the key shareholders to support the MDB."

In general, Fitch now appears to take a more nuanced view of callable capital. First, the 2012 criteria now say that "Fitch's analysis of support focuses both on the ability and willingness of member states to provide that callable capital in a timely manner." In terms of ability, "Fitch's underlying principle when assessing the capacity of shareholders to provide support is to give credit to callable capital provided by shareholders rated 'AA-' or above." In terms of willingness, Fitch says that this "largely depends upon the importance of the role of MDBs for member states." Factors it cites include "the size of the institution relative to the region's economy, its role in the financing of member countries, and its reputation. It can also be measured through the amount of capital that member countries have subscribed and disbursed to accompany the growth of the institution and by their readiness to respond to capital increases. The willingness of member states to support an MDB depends largely upon political considerations..."

Beyond these differences in how support is assessed, Fitch is also more conservative in the way it incorporates callable capital into its measure of intrinsic factors. First, it states that "more emphasis is given to equity to assets ratios, while the ratio of usable capital to required capital is given less weight." Second, its measure of capital adequacy is more restrictive, including only callable capital from members with ratings 'AA-' and above, i.e., other investment grade countries' callable capital is no longer included in the calculation. Finally, Fitch says "the ratio of usable capital (equity plus callable capital from shareholders rated 'A-' and above) to required capital (expected losses on loans,

equity participations, treasury assets and off-balance sheet operations) has long been considered as a key measure by Fitch. However, the agency has become increasingly concerned by the much greater resort in recent capital increases to callable rather than paid-in capital...The revised methodology, while not dismissing the importance of the ratio of usable capital to required capital, which will still be computed and published by Fitch, places increased weight on capital ratios based on paid-in capital, and in particular the ratio of equity to total assets and guarantees.”

In sum, Fitch’s updated criteria deem callable capital of countries rated less than ‘AA-’ no longer to be supportive of an MDB’s credit rating. However, its criteria continues to admit the possibility of the callable capital from a lower-rated shareholder bolstering the rating of a higher-rated entity. Put another way, implicitly Fitch it is highly confident that a ‘AA-’ rated shareholder would make a contribution of callable capital to an MDB while defaulting on its own public debt.

2. Standard & Poor’s

S&P’s view of callable capital was always more conservative than that of Fitch, in that it ascribed value only to callable capital from ‘AAA’ rated member countries. The (unstated) rationale for this was that if callable capital were to be viewed as tantamount to shareholders’ equity, only the highest-rated callable capital would warrant that status. In a sense S&P’s criteria was less transparent than that of Fitch, because S&P calculated capital ratios using two measures of capital: balance sheet capital (adjusted when necessary); and balance sheet capital plus callable capital. However, the former criteria never revealed the relative weight attached to each measure. S&P could get away with this because the balance sheet capital positions of the global and large regional MDBs, and even some of the smaller ones, were so strong that they warranted a ‘AAA’ rating without taking into consideration the callable capital. So S&P essentially avoided opining on this matter until the recent update of the criteria.

The proposed updated criteria is much clearer about how callable capital enters into the determination of the ratings on MDBs. First, callable capital is a supplement to the stand-alone rating of the MDB, that is, the rating it would enjoy in the absence of callable capital. Second, when certain conditions are met, the updated criteria propose including in the calculation of the “RAC” ratio—S&P’s proprietary calculation of the risk-adjusted capital ratio—the callable capital of shareholders who satisfy certain conditions. This is a big step forward in transparency.

However, the conditions S&P imposes for callable capital to be included in the RAC ratio may prevent the inclusion of most if not all callable capital. The requirements for the inclusion of callable capital in the determination of an MDB’s rating include:

- “There is a document approved by the MDB’s board of governors declaring that a capital call will be made if management opines that a call is necessary to avoid a default and describing the process by which that MDB would make a capital call.” One concern expressed by S&P for many years is that, in a time of a crisis of sufficient severity to require a call on callable capital, an MDB’s shareholders may decide not to make a capital call when needed because they don’t want or are

not able to make the required contribution, and this provision is designed to address that fear. Of course, it assumes that management would issue such an opinion with the knowledge that shareholders did not favor their doing so.

- “Standard & Poor’s believes that the shareholders are able to make the payment of capital when called. This view is informed by the legal and administrative processes required for the shareholder to make such payment shortly after the capital call.” This reflects the concern that a country whose government is otherwise willing and able to pay would find it impossible to do so in a timely fashion due to its own procedures for authorizing and appropriating such a payment.
- “Standard & Poor’s believes that the shareholders are willing to make the payment when called. This view is informed by the shareholders’ record in increasing the MDB’s capital when needed to support its public policy role or its growing activity, and their record in paying on schedule the paid-in capital for general capital increases. This assessment is not limited to the specific MDB, but extends to shareholders’ record in promptly paying capital subscriptions to other MDBs for which they are members. In cases of failure of shareholders to make their payments of capital subscriptions, or repeated arrears on capital subscriptions, we would consider their willing to make payment on callable capital as low. Conversely, recent increases in paid-in capital by shareholders would affect positively our assessment of shareholders’ willing to support the MDB.” In part, this reflects the failure of the U. S. government to pay on time its scheduled capital contributions to the Inter-American Investment Corporation, as well as a broader concern about the behavior of the U.S. Congress.

Should these three conditions be satisfied, then callable capital can in effect be added to balance sheet capital in calculating the RAC ratio, so long as the foreign currency rating on the country whose callable capital is being included is equal to or higher than the MDB’s issuer credit rating resulting from the ratio enhanced by the addition of that callable capital. Put another way, the callable capital of a AA+ shareholder cannot be used to elevate the issuer credit rating of an MDB to a level higher than ‘AA+.’ This restriction means that the callable capital of the U.S., which is now rated ‘AA+’, can provide no support to the ‘AAA’ rating of any MDB. Likewise, when any other country is downgraded from ‘AAA,’ its ability to support a ‘AAA’ rating through its callable capital disappears. This, of course, puts more pressure on balance-sheet capital to maintain the existing rating.

Annex E
**An Assessment of IDB's Risk and Financial Management Policies from the
Perspective of Rating Agencies**

1. Potential impact of IDB's current capital adequacy policy and loan charge methodology on the Bank's AAA rating

S&P, Fitch, and Moody's each use their own methodologies to determine their ratings on MDBs, which include both quantitative and qualitative factors (in Moody's case we infer that from its reports on MDBs, since it has no published MDB criteria). There may be some convergence underway as each has updated its criteria for rating MDBs (Fitch) or is in the process of doing so (S&P, and reportedly Moody's).

Each agency has its own measure(s) of capital adequacy. As a consequence, once it satisfies itself that an MDB has a reasonable framework in place to calculate, monitor, and project capital adequacy, the details of that framework are of only limited interest. The existence and workings of an income model are of even less interest, given that profitability *per se* is generally not a focus of the rating agencies. Profitability is considered principally as it impacts capital adequacy and the growth of capital over the medium term.

Rating agencies historically have differed in how they calculated both capital and risk. The key outputs of MDBs' financial and risk models for ratings purposes thus depend on each rating agency's own methodology. In general, the rating agencies' quantitative methodologies are less complex and sophisticated than those of MDBs; on the other hand, the agencies include qualitative factors.

By far the single most important quantitative factor is each agency's measure of capital relative to risk—especially credit risk in loan portfolios (and equity portfolios for those MDBs with significant equity investments). Ensuring sufficient balance-sheet capital to satisfy each rating agency's capital adequacy requirements is the key contribution of IDB's capital adequacy modeling to maintaining its 'AAA' ratings.

The importance attached to being counter-cyclical lenders varies across institutions. In some cases the desire to be counter-cyclical lenders is expressed through having available "emergency lending" programs. It is also expressed simply through maintaining the capacity to grow lending while commercial lenders are cutting back.

2. IDB's methodology to calculate IDB's Economic Capital and its contribution to ensure proper internal alignment with the preservation of the AAA rating

The rating agencies differ among themselves in their calculations of risk-weighted assets. However, both S&P and Fitch use frameworks that calculate expected losses from the loan portfolio as the products of exposures at default times probabilities of default times losses given default. Thus, they are in broad agreement with IDB's key calculations. Fitch's criteria uses loan concentration as one of its "intrinsic factors" ("five largest

single exposures/gross loans”), while S&P addresses loan concentration by explicitly incorporating the geographic and industry distribution of MDBs’ loans into its calculation of risk-adjusted capital ratios. Loan concentration has a large impact under S&P’s methodology.

3. CUR desired band and adjustment zones contribution to ensure the AAA Rating.

CUR bands are likely to be of little significance to rating agencies. The focus is on the higher end of the CUR band, since that signals greater risk relative to risk-bearing capacity, as defined by the rating agencies’ own methodologies.

S&P’s draft revised criteria provide better guidance on how much IDB might increase its lending while maintaining its ‘AAA’ rating, but it would be necessary to know exactly how the agency assesses certain qualitative aspects of the Bank to be highly certain (see Annex II). An educated guess is that there is some, perhaps substantial, scope for several global and regional MDBs, IDB among them, to operate with lower capital ratios while maintaining their ‘AAA’ ratings from S&P, provided they have significant “eligible” callable capital.

The rating agencies’ principal concern is that capital adequacy, as they each measure it, is sufficient and is projected to remain sufficient to satisfy the requirements of their methodologies. As a consequence, they will be concerned almost entirely with where risk relative to capital is highest. Lower risk relative to economic capital simply enhances the creditworthiness of the institution from a credit rating perspective, but this yields little benefit to a ‘AAA’ rated institution.

4. Impact of the Unused Borrowing Capacity Buffer on the Bank’s ratings.

As common as a mechanism like IDB’s “Policy-based Borrowing Authority” (PBA) is among MDBs, it is not something to which rating agencies—certainly not S&P historically—pay much attention. Accordingly, the Unused Borrowing Capacity Buffer does not directly impact ratings. Nor should it.

The IDB’s PBA apparently goes back to its first bond issue, for which it was seeking a ‘AAA’ rating from S&P and Moody’s. As support for this transaction, included in the bond documentation was a covenant that borrowings would not exceed the callable capital of its then only non-borrowing member country, the U.S., which had a ‘AAA’ rating from S&P at that time.

This policy evolved with the addition of other non-borrowing members and other factors into the current policy, which limits total borrowings (after swaps) and gross guarantee exposure, less qualified liquid assets (after swaps), to the callable capital of non-borrowing members. The problem is that under S&P criteria, callable capital from non-‘AAA’ rated shareholders cannot support a ‘AAA’ rating. With net borrowings much

higher than the callable capital of ‘AAA’ rated members, the PBA no longer works to support S&P’s rating on IDB’s debt based on the original rationale.

Thus, the PBA in principle supports the Bank’s rating solely by limiting the size of the loan portfolio. But this is a blunt instrument for ensuring creditworthiness. In particular, it ignores changes through time in the risk in IDB’s loan portfolio and in its other assets. These risks can and have changed substantially through the years. For instance, there is clearly less risk in IDB’s sovereign loan portfolio today than 10 years ago, and there is likewise less risk in its securities portfolio than was true five years ago. Yet it is now operating under that same PBA constraint that it had in the past.

While there may be—or at least may have been—some presentational advantages to the PBA, the loss of so much of IDB’s ‘AAA’ callable capital (at least in the eyes of S&P) has eliminated the original rationale for the PBA. And other, more focused policies better address the key fundamental factors of liquidity and capital adequacy. The PBA is an anachronism that directly contributes little if anything to the Bank’s ratings.

Management Comments

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Mid-Term Evaluation of IDB-9 Commitments
Background Paper: Risk and Financial Management
Management Response

I. INTRODUCTION

- 1.1 Management welcomes OVE'S evaluation of the Bank's implementation of the IDB-9 requirements related to risk and financial management. The findings presented in this background paper will contribute to the Bank's efforts to strengthen its risk and financial management framework.
- 1.2 Management wishes to thank OVE for the constructive dialogue during the preparation of the paper. Management is pleased to see that some of its observations and suggestions on the earlier draft of the paper were incorporated in this final version.

II. OVERALL FINDINGS AND SUGGESTIONS

- 2.1 Management values OVE's insights into the Bank's risk and financial management work. Management broadly agrees with the evaluation's findings and suggestions, and particularly appreciates OVE's acknowledgement that the IDB has largely met the formal requirement of the IDB-9 in the area of risk and financial management, needing only minor adjustments going forward. Other findings and suggestions that Management fully supports, relate to:
 - i) the need to "enhance the usefulness of IDB-9's financial and risk management models in decision-making." As stressed by OVE, Management believes that the Income Management Model (IMM) and the Capital Adequacy Policy (CAP) could both be further integrated in the Bank's decision making on programming, product design and transfers; and
 - ii) the need for the Governors to define the extent of the counter-cyclical capacity desired for the Bank. As stated in the paper, the Bank has "relied on opportunistic actions, like front-loading of lending during crises and the recent introduction of a countercyclical instrument that relies on IDB-9's capital build-up until 2015". However, both OVE and Management realize that "there is a trade-off between IDB's countercyclical capacity and its current lending charges, as higher charges would be needed to build capital for a future countercyclical response."
- 2.2 While Management welcomes the overall quality of the analysis, it would like to address several points that require further clarification.
- 2.3 Capital Requirements for sovereign guarantee (SG) versus non-sovereign guarantee (NSG) lending: OVE uses a comparison with other multilateral development banks (MDBs) to conclude that the Bank's capital requirements for SG lending are too conservative while those for NSG are too low. The paper also states that the IDB capital requirements "... differ from other MDBs, which require up to twice as much capital for

NSG exposures as SG exposures". While the statement as such is true, the figures used in the paper to illustrate the point bear a different interpretation. The IDB requirements for NSG lending have been, on average, 23% of volume - in line with those at the IFC (22%) and EBRD (20%). Only the AfDB, with likely a much riskier portfolio, stands out with requirements of 42%. Similarly, the IDB's SG requirements of 27% of volume are in line with the AfDB (29%) and IBRD (23%). Only the EBRD has substantially different SG requirement at 10% of volume.

- 2.4 Furthermore, comparing IDB's 10-year non-accrual simulation to simulations over shorter periods at EBRD and AfDB, the paper concludes that *"overly restrictive assumptions that are not based on data could make IDB less competitive"*. This analysis omits some important considerations. First, IBRD and ADB use the same 10-year simulation as the IDB. And secondly, capital adequacy has so far not been the binding constraint in the LTFP - the unused borrowing capacity (UBC) has -, and has thus not affected IDB's competitiveness. Lastly, Management believes that any assessment of the Bank's capital adequacy needs to incorporate, in addition to comparable peer MDBs, also the views of rating agencies given the recent introduction of risk adjusted capital ratios in the assessment of the Bank's financial standing.
- 2.5 Inclusion of portfolio growth in SG capital requirements: To support the suggestion to apply LTFP loan growth under the CAP simulations, the paper argues that while the current zero growth assumption *"may simplify the calculation of net interest income as well as appropriate capital to undisbursed balances, it also results in an overestimation of new disbursements, when compared with IMM assumptions"*. Management wants to clarify two points here: (i) the reason for the zero growth assumption was that it was deemed appropriate to assume that the IDB's total outstanding portfolio loan portfolio would not grow further if more than 20% of outstanding loan balances (OLB) were in non-accrual status, and (ii) the zero growth assumption represents much lower disbursements than the LTFP assumes and, as such, result in lower capital requirements.
- 2.6 Inclusion of concentration in SG capital requirements: The paper suggests that the CAP does not account for the concentration in the Bank's SG portfolio and brings it in context with correlations between exposures. This analysis requires some clarification and a broader conclusion. The CAP is not, as described in the paper, an "operation-by-operation approach", where each loans behaves independently. The CAP simulation is sound in that it moves all SG loans in a given country into non-accrual status if any one of them is simulated as not paying. As such, concentrations are correctly reflected in the CAP. The simulation falls short since it does not take into account the fact that the reason for one country's payment problems could also affect other countries at the same time. OVE correctly raises this point in the paper. However, OVE's recommendation also falls short as it focuses exclusively on the concentration of exposures, which is included in the CAP.
- 2.7 Elimination of the borrowing capacity constraint: The paper suggests that the Bank could lend at volumes greater than it currently can (approximately \$12b p.a. through 2020, and less beyond that), by eliminating the current policy limit on borrowings, based on the callable capital of non-borrowing members, and replacing it with some other metric such

as a leverage ratio. OVE argues that doing so would allow the Bank to lever its capital further and thus increase lending.

- 2.8 Management agrees that one way to increase the Bank's lending capacity is to lever its existing capital level further. Management also believes that callable capital, as a concept, may be reaching the end of its usefulness, particularly given the lower importance that the rating agencies are assigning to it, especially if it's not AAA. Sooner or later, the Bank may have to change its borrowing policy limit to base it on some other non-risk based metric other than the callable capital of non-borrowing members.
- 2.9 Competitive loan charges: Management agrees with OVE's finding that *"The IMM, and to a lesser degree the CAP, define SG charges through a predominantly inward looking process."* As stated in the paper, this is by design, and in comparison with the previous policy, this option reduces the Bank's ability to respond to competitive pressures. However, the document does not fully recognize that by reducing loan charges and thus reducing the coverage of administrative expenses, capital accumulation is also reduced.
- 2.10 Capital accumulation rule: With respect to the capital accumulation rule followed in the IMM, OVE suggests that *"the IMM role of guiding capital accumulation follow industry standards."* OVE's argument is that, as implemented, the capital accumulation rule introduces volatility in the management of the Bank's capital. Management supports this opinion as it recognizes that in the last three years there has been volatility in the management of the Bank's capital and financial planning. Management intends to consider ways to reduce the effect of volatile forward-looking capital requirements into the financial planning of the Bank.

III. LOOKING FORWARD

- 3.1 Management has been continually improving its approaches in the areas of risk and financial management. The annual review of the CAP has been performed, as scheduled, in the past two years, and has resulted in important enhancements and modifications to the framework (inclusion of risk in the Bank's retirement plans and the recalibration of the risk appetite for derivatives in counterparty risk). As part of this year's review, Management is planning to expand the CAP from a "snapshot" approach that determines capital requirements for the current date, to a forward looking tool that would project such requirements taking into account anticipated portfolio changes as well as potential rating and interest rate changes. In addition, as part of the 2013 Business Plan, RMG will review the possibility to build internal quantitative models that would facilitate the CAP to incorporate correlations among borrowers and scenario analysis based on macro-economic variables. As this represent an important undertaking, RMG will seek to reach consensus within Management and also at Board level before engaging any resources.
- 3.2 The Finance Department continues to enhance its financial projections models and will study and propose to the Board changes in the way that the potentially volatile forward-looking capital needs should be introduced in the IMM so as to reduce the volatility that they may introduce into the financial planning of the Bank.

ANNEX I: OTHER CLARIFICATIONS

- 1.1 Footnote 26 correctly states: “The zero portfolio growth for SG and NSG leads to a level of disbursements in the simulation that exceeds several times the actual undisbursed balances”. For the June 30, 2012 run, the zero growth assumption resulted in \$63 billion of disbursements over the next 10 years, about 2.5 times the undisbursed balance of \$25 billion. However, this compares to \$103 billion that the LTFFP projects over the same 10-year period.
- 1.2 Abstract, Page ii, 2nd Paragraph: “IDB-9’s historical reliance on callable capital has declined in importance as a rating criterion.” S&P’s new rating methodology uses callable capital from “AAA” member countries as an important input in its assessment of a MDB’s capital adequacy. For the IDB, it currently raises the assessment of the financial dimension of the rating from “strong” to “extremely strong” (2 notches)
- 1.3 Paragraph 2.15, 2nd Bullet: “This external ratings-based approach may be overly restrictive, and not fully indicative of the SG risk profile of the Bank.”²⁴ and Footnote 24: “The IBRD Probabilities of Default rates are significantly lower than those of the rating agencies for sovereign borrowers.”: The combination of these statements creates the impression that the CAP is relying solely external PDs to assess SG credit risk. However, even though external PDs are an important input other factors are taken into account in order to reflect the Bank’s preferred creditor status. The resulting PDs for the IDB’s SG borrowers have been compared against the ones of the World Bank. However, a full calibration against IBRD’s PDs was not possible because IBRD does not share detailed information. Nonetheless, at the portfolio level and for similarly rated countries IBRD’s PDs were slightly less conservative.
- 1.4 Paragraph 2.26: “Also, a large portion of the Bank’s risk data aggregation will be dependent on the new ICAPA, which still has some shortcomings. While it can now pull together data from various systems for consistent application to different risks and portfolios, there are still programming errors and time lapses.”: This text is incorrect. There are no programming errors in ICAPA. Certain, specific structured debt products can currently not be modeled in the “off-the-shelf” product. A vendor enhancement is being prepared and a workaround is in place. While ICAPA is used with respect to multiple areas of risk management, no outputs related to this shortcoming are utilized
- 1.5 Abstract, Page ii, Last Paragraph: “Countercyclical capacity is further constrained by the adoption of an inherently procyclical CAP that reacts to downturns by reducing lending exposure.” and Paragraph 3.23: “The Bank’s countercyclical lending capacity is constrained by the inherently procyclical CAP. The CAP, applied to a fixed capital base, reduces lending portfolios when they become riskier. Under “strained” conditions, such as a selective default of a large borrowing country, the CAP determines that the CUR desired bands will increase, to reflect that more capital is required for the increase in risk exposures. This causes a reduction in the sustainable lending program, thus making the CAP procyclical.”: The CAP does not determine any lending volume, that is the role of the LTFFP/IMM. What the CAP does, as it should, is measuring the increase in risk during a downturn. Lending volumes are determined by the Board based on LTFFP/IMM output.