



*RE-386*

*Oversight Note on Credit Risk  
Management*

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*Office of Evaluation and Oversight, OVE*

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## ACRONYMS

|         |   |
|---------|---|
| BIS     | Bank of International Settlements                               |
| CRCs    | Credit Risk Classification System                               |
| CRM     | Credit Review Meeting   |
| EIA     | Environmental Impact Assessment                                 |
| ERM     | Eligibility Review Meeting                                      |
| ESG     | Environmental Safeguards Unit                                   |
| EVP     | Executive Vice Presidency                                       |
| FIN     | Finance Department  |
| FMK     | Financial Markets Division                                      |
| ICF     | Institutional Capacity and Finance Sector                       |
| IDB     | Inter-American Development Bank                                 |
| INE     | Infrastructure and Environment Sector                           |
| INT     | Integration and Trade Sector                                    |
| IO      | Investment Officer from SCF or OMJ                              |
| ITE     | Information Technology  |
| ITE/ISS | Information Technology Shared Services Unit                     |
| LEG     | Legal Department  |
| LGA     | Loan or Guarantee Agreement                                     |
| LGP     | Loan or Guarantee Proposal                                      |
| LMS     | Loan Management System  |
| MIF     | Multilateral Investment Fund                                    |
| NARC    | Non-Accrual Review Committee                                    |
| NSG     | Non- Sovereign Guaranteed Operations                            |
| OMJ     | Opportunities for the Majority Sector                           |
| OPC     | Operations Policy Committee                                     |
| OPUS    | Operation Update System   |
| ORP     | Office of Outreach and Partnerships                             |
| OVE     | Office of Evaluation and Oversight                              |
| PMO     | Portfolio Management Officer                                    |
| PMU     | Portfolio Management Unit                                       |
| PRIS    | Private Sector System   |
| PSR     | Project Supervision Report                                      |
| QRR     | Quality and Risk Review Meeting                                 |
| RAMP    | Rating Methodology Profiles                                     |
| RC      | Credit Risk Rating  |
| RMG     | Office of Risk Management                                       |
| SAO     | Special Assets Officer  |
| SCF     | Structured and Corporate Finance Department                     |
| SCF/PM  | Portfolio Management Unit                                       |
| SCF/SAU | Special Assets Unit   |
| SG      | Sovereign Guaranteed Operations                                 |
| SPD     | Office of Strategic Planning and Development Effectiveness      |
| TFPP    | Trade Finance Facilitation Program                              |
| VPC     | Vice Presidency for Countries                                   |
| VPF     | Vice Presidency for Finance and Administration                  |
| VPP     | Vice Presidency for Private Sector and Non-Sovereign Guaranteed |
| VPS     | Vice Presidency for Sectors and Knowledge                       |
| XPSR    | Expanded Project Supervision Report                             |

## EXECUTIVE SUMMARY

In pursuit of its mission to reduce poverty and inequality and foster sustainable growth, the Bank interacts not only with its public sector borrowing member countries, but also with private sector actors engaged in activities aligned with the Bank's mission.<sup>1</sup> Under the guidance of the Vice Presidency for Private Sector and Non-Sovereign Guaranteed Operations (VPP), four windows within the IDB Group - SCF, IIC, MIF and OMJ - engage these private sector entities directly, without the explicit support of sovereign guarantees.

These non-sovereign guaranteed operations (NSG) expose the Bank not only to the customary strategic, compliance, environmental and social risks, but also to a greater degree of operational and financial risks.<sup>2</sup> Operational risks refer to potential losses from inadequate or failed internal processes or systems, human errors, or external events. Financial risks relate to potential losses due to market, liquidity, concentration and credit risk.

This note focuses on the Bank's management of credit risk for NSG operations. It excludes operations by the IIC and MIF because these organizations manage this risk independently from the Bank. Among all risks, it highlights credit related risk which has been of increasing relevance to the Bank. The successive increases in private sector exposure caps have brought about the need for sustained refinements in the Bank's capabilities to manage credit risks.

Simply put, **credit risk management is a two-step process - determining what credit risks exist and then handling those risks in the way best-suited to achieve predefined objectives.** This handling involves either action (mitigation) or inaction (acceptance) of each identified risk in a way that better matches the credit objectives and risk tolerance of an organization. The effectiveness of this process usually depends on the credit risk management environment, the soundness of the loan and guarantee granting and administration systems, risk measurement and monitoring processes, and the credit risk control and oversight.

The Basel Committee for Banking Supervision has issued a set of "Principles for the Management of Credit Risk" which are generally used as a benchmark by financial institutions. Although the Bank is not technically subject to these or any other Basel standards, OVE has used them as guidelines for this assessment. This approach has been embraced by management as an opportunity to subject the credit risk system in place to a higher, industry-proven standard.

It is worth noting that The Basel Principles on Credit Risk Management are meant to be independent of the organizational arrangements utilized for their implementation. However, it's evident that they clearly emphasize the effects of operational areas over credit risk (in this case, SCF and OMJ). In consequence, by following the principles, this note is not meant to be any sort of comprehensive assessment of other areas related to credit risk management, particularly of RMG. Such undertaking would require a completely different focus and methodology, and also would probably be untimely for an OVE evaluation given RMG's relatively recent inception.

OVE concludes that **the Bank largely complies with Basel's credit risk management principles**, but nevertheless there are opportunities for improvement. Firstly, OVE recommends that the Bank adopt a comprehensive **Credit Risk Framework** that clearly defines its **risk appetite towards NSG**. Such framework should spell out the **objectives and**

**procedures supporting the desired NSG loan/guarantee portfolio.** In addition, it is highly recommended to **clarify the roles and responsibilities** of the originating areas (SCF, OMJ) and RMG along the life-cycle of an operation.

It's also recommended that the Bank **strengthens the Portfolio Management Function** to complement the current credit administration and risk management functions, being carried out by the originating divisions within SCF and OMJ, PMU and RMG.<sup>3</sup> The strengthening of this function is expected to improve the Bank's control of its loan/guarantee portfolio. Concrete steps towards accomplishing such strengthening include, for example, the institutionalization of NSG portfolio periodic stress testing exercises, portfolio management discussions and watch-list meetings. It is also worth noting that this recommendation calls for a strengthening of the function, but does not prescribe a specific organizational design, which is left to be selected by management.

The Bank should also address the risks posed by the current absence of an **integrated information system** to support the loan/guarantee granting, administration, risk and portfolio management. It is worth noting that this shortcoming has pervasive effects, affecting full compliance with 7 out of the 17 Basel credit risk management principles; and being the single main reason compliance gaps exist. Although management has actively tried to compensate for this by using manual procedures and non-integrated information systems, this approach presents weaknesses as the NSG portfolio grows over time. Further complicating the situation, NSG management lacks direct control over IT capital investments, a significant part of which has so far fell under the Optima initiative.

Private financial institutions usually have specialized procedures for the treatment of exceptions and related party transactions. In contrast, the Bank utilizes the same procedure for these types of operations, particularly those more closely connected to the Bank's developmental mandate and particular constituency's agendas. OVE considers that either of these practices is feasible and recommends that **performance in this area be monitored over time in order to adapt the Bank's approach to the evolving needs.**

Finally, given the priority the Bank has given to working through the private sector, the general risk governance of its loan/guarantee operations shall be timely supported. Unlike its counterparts in the private banking sector, the Bank is not subject to an independent supervisory authority. To this end, the Bank should **assess the cost-benefit trade-offs of securing the availability of some basic supervisory framework to complement governance in connection with the Bank's NSG exposure.** Such framework could be implemented either throughout the current Bank's organizational structure –including any potential role within OVE current mandate- or the external services of specialized panel of consultants.

## I. METHODOLOGY

- 1.1 To assess the Bank's soundness regarding credit granting, administration and control procedures as well as the adequacy of the credit risk management for non-sovereign guaranteed (NSG) operations, the Office of Evaluation and Oversight (OVE) adopted combination of a top-down and bottom-up approaches. Working top-down, OVE reviewed credit risk administration and management by verifying the consistency of the Bank's risk management process and risk tolerance with its policies and operative framework.
- 1.2 Working bottom-up, OVE assessed the loan and guarantee portfolio by conducting a detailed review of 100% of the operations originated by the Structured and Corporate Finance Department (SCF) as of December 2008.<sup>4</sup> This process, aside from seeking to determine the quality of such assets, segregated by country, also intended to confirm compliance with the Bank's financial and operating policies; individual compliance with loan covenants and conditions; and to identify any concentration in the portfolio.

### A. Top-Down Assessment: Credit Risk Principles

- 1.3 The "Principles for the Management of Credit Risk" (Principles) issued by the Basel Committee for Banking Supervision in September 2000 were used as a benchmark. These seventeen principles are divided into five areas that appropriately cover the credit risk management process. These are: (i) the credit risk environment; (ii) the credit granting process; (iii) the credit administration, measurement and monitoring process; (iv) the credit risk controls and (v) the supervisory framework. These Principles are meant to be independent of the organizational arrangements utilized for their implementation. However, it's evident that they clearly emphasize the effects of operational areas over credit risk (in this case, SCF and OMJ). In consequence, by following the Principles, this note is not meant to be any sort of comprehensive assessment of other areas related to credit risk management, particularly of RMG. Such undertaking would require a completely different focus and methodology, and also would probably be untimely for an OVE evaluation given RMG's relatively recent inception.
- 1.4 OVE assessed the Bank's current compliance with these seventeen principles and classified the results into one of the following four categories: (i) **Materially Compliant** - A principle was considered materially complied with when all essential criteria were met without any significant deficiencies; (ii) **Largely Compliant** - A principle was considered largely complied with when only minor shortcomings were observed which may not have a material impact on the operations being analyzed or appropriate actions were being taken to achieve full compliance; (iii) **Largely Non-compliant** - A principle was assessed as largely non-complied with when severe shortcomings were identified and no material actions to resolve them were being taken; and **Materially Non-compliant** - This category was used when there was no evidence of the principle being complied with or there were no effective controls in place.<sup>5</sup>
- 1.5 The review covered the Bank's strategies and policies related to the project approval process and portfolio management, as well as the procedures and operating framework in place, which are summarized in Annex I. The individual compliance assessments were supported not only by this documentary review, but also by interviews with SCF's management, officers as well as senior officials outside SCF. These were also intended to verify the degree of understanding and adherence to current policies on the part of management and officers.

1.6 A senior external evaluator was retained by OVE to conduct this assessment. The evaluator's experience and criterion during the assessment process were instrumental. The effort was also supported by three expert professionals in the field, several of them former banking supervisors in the Region.<sup>6</sup> The note is structured to provide a brief summary of each one of the seventeen principles, a description of what would be implied in an appropriate implementation by a financial institution, and a detailed description of current Bank practices in relation to each principle. Finally, the note assesses whether the Bank complies with the principle and, in the event of non-compliance, it provides guidance in the form of specific recommendations.

## **B. Bottom-up Assessment: Risk Classification**

1.7 To complement the top-down assessment, OVE also reviewed the quality of the risk analysis of individual loans/guarantees. For that purpose, OVE engaged an expert consultant to re-rate the risk classification of the complete SCF portfolio as of December 31, 2008 - the latest complete set for which the Bank had updated risk classifications at the time. This review was not structured as an audit. Instead, it was carried out as an independent verification customarily performed by bank supervisors. The methodology adopted specifically referred to each one of the three types of loan/guarantee operations the Bank offers. Therefore, structured and project finance had a different methodological approach from that of corporate loans and guarantees and financial institutions.

1.8 Structured and project finance operations were assessed to identify any issues in project development that may ultimately affect repayment. The focus of this assessment was the operation's source of repayment, while other elements (i.e. environmental), although important, were considered secondary from a credit rating perspective. Structured and project finance operations included the following analyses: (i) the verification of the completeness and validity of each operation's documentation; (ii) the analysis of the terms and conditions of loan contracts, identification of any amendments, and compliance with the agreed upon terms. In the event of non-compliance, the reasons were noted as well as the corrective actions reviewed. If there were waivers to loan covenants, their impact on potential repayment and the appropriateness of approval were also assessed; (iii) the identification of compliance with original time frames established for project development and compliance with original projections. This included the revision of corrections and changes made during project implementation; (iv) the revision of internal and external changes made to project's development; (v) the assessment of country risk; (vi) the assessment of the project's risk and mitigation actions; (vii) the conceptualization of the project from a risk perspective as well as the stability of the target market it was being developed for; (viii) the project's financial management and compliance with original projections as well as the analysis of significant deviations; (ix) the compliance with environmental requirements and (x) the evaluation of the project's completion risks and the quality and accessibility of the guarantees committed.

1.9 Corporate loans and guarantees were reviewed from a borrower's financial and operation strengths perspective seeking to identify weaknesses that may compromise the operation's repayment. The review focused on the analysis of historical and current audited financial statements, prior record of obligor, industry considerations (market conditions and trends), and other factors as a function of the type of obligor and requested financing, to determine (i) the feasibility of continued beneficial operations, (ii) the financial condition and strength of the entity, and (iii) the level of shareholder's support.

- 1.10 Financial Intermediary operations also took into account the assessments already produced by host country's supervisors. Commercial banks' financial and operative strengths were further analyzed to determine their soundness. To this end, the CAMEL methodology was adopted to analyze each bank.<sup>7</sup> The latter was complemented by the analysis of internal and external factors such as corporate governance and competitiveness to arrive at conclusions over the current and potential future conditions of a banking institution. Finally, Capital Markets operations were analyzed using standard industry practices and, if publicly available, any third party rating information.

## II. COMPLIANCE WITH CREDIT RISK MANAGEMENT PRINCIPLES

- 2.1 The Principles define credit risk "*as the potential that a ... borrower or counterparty will fail to meet its obligations in accordance with agreed terms.*" Furthermore, they state that "*the goal of credit risk management is to maximize [the institution's] risk-adjusted rate of return by maintaining credit risk exposure within acceptable parameters.*" The Principles also require managing "*the credit risk inherent in the entire portfolio ... the risk in individual credits or transactions (as well as) the relationships between credit risk and other risks.*"
- 2.2 While the Principles are generally applicable to any financial institution undertaking credit risk; IDB's goals differ from private financial institutions' objectives. Specifically, the IDB is not only concerned with maximizing a private risk-adjusted rate of return, but also is directed towards the maximization of an economic rate of return considering the developmental potential of the projects. Therefore, these dual objectives place an additional challenge versus those faced by institutions purely focused on credit risk.
- 2.3 The Principles help assess the soundness of the credit granting environment and processes; the adequacy of the credit administration, measurement and monitoring processes; the appropriateness of credit risk controls; and the supervisory framework. This chapter assesses the Bank's compliance with each principle; and provides recommendations on: (1) Credit Risk Management Environment; (2) Credit Granting Process; (3) Credit Administration, Measurement and Monitoring; (4) Credit Risk Controls; and (5) Supervisory Framework.

### A. Credit Risk Management Environment

- 2.4 The first three credit risk management principles deal with the manner in which an organization sets its credit risk strategy, as well as the high level policies and procedures supporting its implementation. These principles ensure that the organization define a specific risk appetite and expected results regarding credit risk; as well as a set of basic guidelines on "how things are done" in relation to credit granting and management. These essential elements define the organization's credit risk management framework, in a way that has to be consistent with the expected results it seeks through its lending and investment activities.



### Box 3.1: Setting an Appropriate Risk Environment

- ✓ Principle 1: The Board of Directors should have responsibility for approving and periodically (at least annually) reviewing the credit risk strategy and significant credit risk policies of the bank. The strategy should reflect the bank's tolerance for risk and the level of profitability the bank expects to achieve for incurring various credit risks.
- ✓ Principle 2: Senior management should have responsibility for implementing the credit risk strategy approved by the Board of Directors and for developing policies and procedures for identifying, measuring, monitoring and controlling credit risk. Such policies and procedures should address credit risk in all of the bank's activities and at both the individual credit and portfolio levels.
- ✓ Principle 3: Banks should identify and manage credit risk inherent in all products and activities. Banks should ensure that the risks of products and activities new to them are subject to adequate risk management procedures and controls before being undertaken, and approved in advance by the Board of Directors or its appropriate committee.

- 2.5 These principles highlight the need for consistency between the bank's strategy and how it is made operative through its policies and the development of the corresponding procedures for credit assessment and credit risk management.<sup>8</sup> In particular, the Principles call for "written policies and procedures to identify, measure, monitor and control credit risk (to) enable the bank to: (i) maintain sound credit-granting standards; (ii) monitor and control credit risk; (iii) evaluate new business opportunities; and (iv) identify and administer problem credits".
- 2.6 According to these principles, a bank's Board of Directors (the Board) has the responsibility of establishing its credit risk environment through the identification of its risk appetite and the approval of a credit risk strategy, its corresponding policies and relevant procedures. It is worth noting that **risk appetite is not a synonymous for risk tolerance**. Indeed, risk tolerance refers to the limits the Bank has placed to be able to absorb its involvement in NSG operations under different scenarios. By contrast, risk appetite is the proactive expression of the level and type of risk the Bank is willing to embrace in order to pursue its mission via NSG operations.
- 2.7 In addition, the Board is charged with the creation of different Board Committees and the definition of the operative levels that would ensure an adequate management of risk exposures. Finally, as the business evolves, the Board would have to regularly assess the compliance with the defined risk management policies and procedures and approve any change as needed. Senior management on the other hand, is responsible for developing policies and procedures' proposals, as well as to disseminate and efficiently implement them.

#### 1. Principle 1: Credit Risk Environment

- 2.8 As noted above, Basel principles refer to the need of a "credit risk strategy". In the context of the Bank, however, the word "strategy" has a different connotation; especially after the Ninth General Increase in the Resources of the IDB that calls for the Bank to preselect a few areas where it would develop strategies. Thus, in the remainder of the document, this Basel call for a "credit risk strategy" will be translated as a "credit risk framework". Such "framework" incorporates both elements of risk appetite (mostly under the control of originating units within

SCF and OMJ), as well as credit risk guidelines for origination, underwriting and monitoring (mostly under the responsibility of RMG).

- 2.9 Consistent with its institutional objectives, the Bank has repeatedly raised its statutory ceiling on NSG lending, thus increasing its potential credit risk exposure. At the beginning of this evaluation the Bank had no specific sector or country concentration limits, which are customarily used by financial institutions as a high level guideline to help mitigate these risks. However, during the course of the evaluation, Management prepared a proposal on NSG concentration limits for the Bank which was approved by the Board in December 2010.<sup>9</sup>
- 2.10 At the time of this evaluation, the Bank had not yet defined an integral risk framework, a point that was also highlighted in a recent report by the Office of the Auditor General (AUG).<sup>10</sup> Nevertheless, there are several Bank documents that describe components which could serve as a basis to formulate such framework.<sup>11</sup>
- 2.11 The lack of an explicit credit risk framework exposes the Bank to: (i) potential risk implications related to the trade-off between desired developmental outcomes and financial exposure; (ii) situations where concentration levels on sectors or countries may place unexpected levels of capital at risk;<sup>12</sup> (iii) the promotion of a credit environment where loan production would be the primary objective over other factors to be pursued by the Bank; (iv) the structuring of complex operations in diverse economic sectors or regions with insufficient capacity to manage them.<sup>13</sup>
- 2.12 **Assessment:** The Bank lacks a definition of its risk appetite and a clearly articulated Credit Risk Framework. However, several Bank documents constitute a good basis to formulate it. For example, concentration limits per sector have been already defined and pricing memos coupled with quarterly reviews evidence a risk-based pricing practice. Therefore, the Bank is **largely compliant with Principle 1.**
- 2.13 **Recommendation: Develop a Credit Risk Framework by first identifying and defining the Bank's risk appetite towards the private sector in a manner that is consistent with institutional objectives.** This framework should encompass: (i) the risk implications derived from implementing the NSG Strategy; (ii) the mix of economic sectors, geographic areas and products targeted by the bank and their implications on the expected quality of the credit portfolio; (iii) specific risk approach and underwriting standards by product and sector if needed; and (iv) the portfolio credit rating allocations and triggers.

## **2. Principle 2: Policies and Procedures**

- 2.14 The 2006 Operational Guidelines for Non-Sovereign Guaranteed Operations establish a set of general rules based on the concept of flexibility in their implementation, with the explicit objective of not deterring innovation. The Guidelines indicate that this flexibility shall be exercised with caution and a conservative approach shall be followed in the structuring of NSG operations. The Guidelines provide some support to investment officers without limitation to country or sector, as long as the debtors do not have sovereign guarantees, the sector is consistent with a country's program and it does not belong to a predefined exclusion list.
- 2.15 The Guidelines are also flexible in relation to the types of operations that may be used to meet the Bank's objectives. From an operative viewpoint, aside from other concepts, the Guidelines

require that creditworthiness be assessed both from a repayment-capacity and a full-credit-analysis perspective, reflected in an assigned credit rating. The Guidelines also set exposure limits for NSG operations to be used on a case-by-case basis and a limit per single obligor; while sector concentration limits are defined in the recently approved NSG Concentration Limits document.

- 2.16 An Office of Risk Management (RMG), organized as an independent unit from the origination areas, is responsible for the Bank's financial risk management.<sup>14</sup> RMG has developed and implemented the Bank's Capital Adequacy Policy (CAP) that measures the capital requirements for credit risk in NSG operations. It follows a solvency test to calculate the capital requirements needed to cover the credit risk, which takes into consideration the outstanding exposures and credit ratings assigned to each individual NSG operation pursuant to the Bank's Credit Risk Classification System (CRCS), the probabilities of default and loss given default.
- 2.17 To monitor risk levels, SCF, OMJ and RMG make use of a Credit Risk Classification System (CRCS), which combines three dimensions – borrower, transaction and sovereign risks - to rate an operation.<sup>15</sup> This system has eight rating levels ranging from excellent (RC1) to impaired (RC8), and the Bank has set its tolerance levels to a fair rating (RC5) for SCF operations and RC6 for OMJ operations, with any lower level placing them under special monitoring / collection processes.<sup>16</sup>
- 2.18 The issue of pricing is addressed by the operational Guidelines, which indicate that they would be set through market comparisons and the operation's risk level under a particular set of macroeconomic and project specific conditions. Furthermore, GN-1860, under Loan Charges, states that "Lending spreads and loan fees will be set so that even after reflecting the higher loan loss provisioning required to cover the additional risk of NSG projects, lending to the private sector has a net neutral impact on the loan charges for the regular OC loans."
- 2.19 In practice, however, the Bank's NSG pricing faces the challenge imposed by its foundational mandate to participate only "*when private capital is not available on reasonable terms and conditions*".<sup>17</sup> Therefore, this often precludes direct comparisons with market conditions. As a result, pricing is mostly derived on the basis of imperfect market comparisons; does highlighting the importance of the assumptions used to interpolate pricing out of observable market conditions.
- 2.20 Nevertheless, the Bank has made significant progress by introducing pricing memoranda to document individual decisions; as well as quarterly pricing reviews to foster consistency. However, the way in which these pricing analyses are being conducted either at the individual or group of operations level, leaves open the possibility that the assumptions underlying these pricing decisions lack consistency over time.<sup>18</sup>
- 2.21 **Assessment:** SCF, OMJ and RMG have issued written general guidelines for the assessment and management of loans and guarantees. However, these guidelines have not yet been integrated within a general credit risk framework. In addition, there is a lack of documented guidelines geared towards specific products and sectors as well as means to ensure consistency of assumptions in key areas such as pricing. Nevertheless, the robustness of current practices in place supports the assessment that the Bank is **largely compliant with Principle 2.**

- 2.22 **Recommendation: Optimize the specificity and consistency of policies and procedures.** Build upon existing policies and procedures to allow for the incorporation of product/sector specific lessons learned and ensure the consistency of credit management.

### **3. Principle 3:- Product and Activity Risk**

- 2.23 According to the evidence collected for this note, the Bank gains what appears to be reasonably sufficient knowledge of operations and their risk by means of the following credit assessment elements: (i) the operative framework described in Annex I; (ii) the loan/guarantee granting, credit risk management, and pricing processes mentioned above; and (iii) the extensive due diligence process the Bank performs for each loan/guarantee assessment.
- 2.24 This assessment appears robust for operations and sectors where the Bank has significant experience. However, no policy or procedure clearly defines the approach to analyze new types of operations or sectors; nor how to measure and mitigate the inherent risks. External experts play a more prominent role in these new areas. Yet their support is usually focused on loan structuring, and less so on loan management and, most importantly, periodic credit rating.
- 2.25 Despite recent improvements, current due diligence procedures still take an average of nine months, raising the prospect that the Bank could still be perceived as a somewhat bureaucratic organization. According to some origination officers, increased uncertainties over social and environmental requirements (especially in new sectors or types of operations) have been responsible for a recent spike in delays and cancellations. Furthermore, an assumption that cannot be proven with the data available is the possibility that this creates an adverse selection effect, leading to less risky operations being financed by other competing sources, while the Bank is potentially left with an inherently riskier pool of operations.
- 2.26 **Assessment:** The Bank's current practice to perform a detailed and extensive due diligence process in every operation allows for a good understanding of the operation's inherent risks. In private financial institutions, the introduction of new types of operations is conducted following specific guidelines geared towards limiting their credit risk exposure. By contrast, the Bank undertakes a fair standardized credit procedure to all operations regardless of the prior experience. Therefore, on the basis of current practice the Bank is **largely compliant with Principle 3.**
- 2.27 **Recommendation: Develop guidance for collecting lessons learned from new groups of approved operations within the portfolio.** In line with the Bank's strategy, the NSG loan/guarantee portfolio is likely to increase in size and complexity in the near future. New products and sectors would likely be part of this growth. Thus the suggested guidance aims at ensuring an adequate knowledge of their inherent risks and the way they could be managed. This ex-post approach will contribute to foster innovation, while at the same time maximize the likelihood of profiting from specific lessons learned by product and sectors.

### **B. Credit Granting Process**

- 2.28 Principles 4 through 7 address the soundness of an institution's credit granting processes. They include limits established to manage exposures, strengths of the credit granting process and the importance of non-interference for reasons other than technical on the building of a quality credit portfolio. Box 3.2 below provides details regarding these principles.

### Box 3.2: The Credit Granting Process

- ✓ Principle 4: Banks must operate within sound, well-defined credit-granting criteria. These criteria should include a clear indication of the bank's target market and a thorough understanding of the borrower or counterparty, as well as the purpose and structure of the credit, and its source of repayment.
- ✓ Principle 5: Banks should establish overall credit limits at the level of individual borrowers and counterparties, and groups of connected counterparties that aggregate in comparable and meaningful manner different types of exposures, both in the banking and trading book and on and off the balance sheet.
- ✓ Principle 6: Banks should have a clearly-established process in place for approving new credits as well as the amendment, renewal and re-financing of existing credits.
- ✓ Principle 7: All extensions of credit must be made on an arm's-length basis. In particular, credits to related companies and individuals must be authorized on an exception basis, monitored with particular care and other appropriate steps taken to control or mitigate the risks of non-arm's length lending.

2.29 A sound credit granting process is based on the alignment of procedures with the institution's objectives and target market priorities. At time a potential operation is identified, the originating area shall first verify that it has appropriate knowledge and that the operation is part of the institution's priorities and expertise. Procedures must include an adequate identification of the source for repayment; instruments to execute the protection of the institution's interests; and flexibility to arrive at structures that add value to the parties involved.

2.30 There are two key factors at this point of analysis. The first one is to clearly identify and describe the repayment source and its stability. The second one is to make sure that any pledged collateral is sufficiently independent in case collection would need to be pursued through legal procedures. These matters shall be part of the institution's loan and guarantee criteria and need to be supported by directives or explicit due diligence procedures. Eligible operations shall be assessed independently by the risk area. This assessment shall then be discussed with originating officers to jointly determine conditions for structuring.

#### 1. Principle 4: Credit Granting Criteria

2.31 The IDB's Operational Guidelines for Non-Sovereign Guaranteed Operations (the Guidelines) provide investment officers with eligibility criteria and decision parameters for loan granting. Eligibility criteria are defined by country and sector, wherein all member countries of the Bank are eligible. In turn, sectors need to match the country's focus, be consistent with the country's program and not match a negative exclusion list. Furthermore, in relation to productive sectors, NSG operations are exclusively targeted to private sector sponsors.

2.32 The Guidelines also indicate that financing facilities would be "tailored to market demand" and its dynamics.<sup>19</sup> Thus, an array of products is established from project financing through corporate finance making use of loans and guarantees. According to the Guidelines, lending products need to meet two objectives referred to the provision of "the most effective financing solution" while adequately managing the Bank's risk standards.<sup>20</sup> Guarantees will be flexibly used to provide partial coverage.

- 2.33 As per creditworthiness, the Guidelines require that projects or borrowers be creditworthy on their own right; or that the operation "be made into an acceptable credit risk" through risk mitigation that gets reflected in the final structuring.<sup>21</sup> Once an operation is declared creditworthy, even though no particular due diligence guidance has been issued in relation to each of the Bank's products or services or the country or sector being supported, the Guidelines require a thorough analysis of the borrower including governance issues. The latter seeks to make sure that the Bank's interests will be duly protected, that there is no undue governmental dependence or interference and that companies are being managed transparently.
- 2.34 During the due diligence process, and with no formally established guidelines, RMG is engaged in reviewing the assessment of the credit risks of NSG operations. Even though general NSG Operational Guidelines include a Quality Risk Review process (which requires the early engagement of RMG in the credit cycle), the terms of this engagement are not clearly defined during the loan/guarantee evaluation process. In practice, the process followed varies among NSG transactions due to differing views on when this should occur. Yet, it is important to provide proper rules and guidelines to avoid any conflicting interactions and increase the quality and timeliness of the final assessment.
- 2.35 The credit granting process is further stressed by the Bank's mandate to engage in operations with a developmental role. This mandate potentially exposes the Bank to higher risk sectors or countries, where often private financiers would be hesitant to become involved. This also may bring to the Bank a pool of complex operations where, even after extensive due diligence, the ability to grasp the borrower's and other risk factors may still be limited.
- 2.36 **Assessment:** There has been evident progress in the Bank's institutional construct to execute NSG operations. Issues to be resolved are the establishment of due diligence procedures per type of operation, sector and country, and the timing of RMG's engagement. Considering the Bank is enriching this process and progressively developing a sound framework, the Bank is **largely compliant with Principle 4.**
- 2.37 **Recommendation: Revise operational guidelines to establish due diligence procedures appropriate to each type of operation, sector and country; and further clarify the rules of engagement with RMG along the process.** Current credit granting guidelines are generic, thus missing on potential lessons learned by type of operation, sector and country. In addition, there is a need to resolve the timing of RMG's engagement.

## **2. Principle 5: Credit Limits**

- 2.38 As per document AB-2442 - Financing Limits for Private Sector Operations - the Bank's maximum exposure to any single NSG obligor shall not exceed 2.5% of the Bank's equity. The NSG guidelines also define some limits per project at US\$ 200 million (or up to US\$ 400 million in exceptional circumstances). It also limits the Bank to 50% of total project costs for expansion projects, as long as IDB's participation does not exceed 25% of the company's debt and equity capitalization, or 40% for companies based in countries C and D. For Greenfield projects, it limits the Bank to 25% of the total project cost, or 40% for C and D countries.
- 2.39 As mentioned before, the Bank has recently defined limits by sector. Such limits are essential for a robust loan/guarantee portfolio inasmuch as it forces a bank to diversify its risk exposures. The current NSG Concentration Limits incorporate the limits established by the Bank in section E of the current Guidelines and further mitigate the potential for portfolio concentration. These

limits do not substitute a thorough analysis of the borrower, which is to be made independently by the Bank, avoiding over-reliance on assessments by any specific third party. In line with industry practices, management had also proposed to set concentration limits by country, but this was not adopted.

2.40 **Assessment:** The Bank has made significant progress in this area. This fact is corroborated by the recently approved NSG Concentration Limits. Therefore, the Bank is found to be **materially compliant with Principle 5.**

2.41 **Recommendation: Ensure an adequate implementation of the established concentration limits.** In line with the recent approval of the NSG Concentration Limits, ensure that its implementation is conducted without an excessive reliance on any single third party/consulting provider; particularly in new sectors where the Bank has little experience.

### **3. Principle 6: New Operations, Refinancing and Renewals**

2.42 The Guidelines are complemented by a set of procedures (2009) describing the cycle of a NSG transaction. These procedures provide for the identification of "credit, technical, environmental and social, institutional, policy or reputational risks"; constituting adequate guidance to manage an operation from its Project Profile stage through its first disbursement. The procedures describe the review and approval processes of a Project Profile (PP), its Draft Loan or Guarantee Proposal (DLGP) and its pre-closing phase. This processing cycle is utilized for every new or significantly modified operation.

2.43 Once the Project Team puts together a PP, it is cleared by the SCF /Manager for circulation to an Eligibility Review Meeting (ERM), which is convened only if observations arise during a four day consultative process. This meeting's objective "is to review the preliminary transaction structure, potential credit, technical, environmental and social, institutional, policy or reputational risks, consistency of the project with Bank policies, its relevance and strategic fit within the country and sector strategy, and the potential for development impact and additionality of the Bank." RMG reviews the credit risk management throughout the transaction approval phase and ratifies the CRCS rating of the NSG operations.

2.44 **Assessment:** The IDB's loan/guarantee granting process follows written procedures wherein all the relevant parties and committees come together. Responsibilities through the process are properly balanced, except for some overlaps in the leadership of the Committees. QRR and Pre-closing meetings are co-chaired by the SCF/OMJ Manager and Country Manager. Checks and balances are further reinforced by allowing any member of these meetings to request an operation to be considered by the Operations Policy Committee - an additional layer of security. Thus, the Bank is materially **compliant with Principle 6.**

2.45 **Recommendation: Continue improving the timing and frequency of interactions between VPP (SCF or OMJ manager) and RMG.**

### **4. Principle 7: Related Parties and Exceptions' Treatment**

2.46 Given its corporate structure, the IDB should in principle not be exposed to related party lending. However, its shareholding by borrowing countries brings political-developmental considerations that might potentially influence the transaction approval decision making process. Indeed, in the past OVE documented at least one operation authorized on these grounds that later led to losses. This case evidenced a clear departure from an arm's length approach to transaction approval granting.<sup>22</sup>

- 2.47 Private financial institutions not only have a credit risk management framework; but also complement it with specialized procedures for the treatment of exceptions and related party transactions. Such procedures usually include stricter approval processes that could only be granted by the Board, thus allowing it to exercise proper oversight. In addition, exceptions also have special monitoring procedures, involving different assessment criteria and a differentiated reporting cycle, regularly followed by the Board.
- 2.48 In contrast, the Bank utilizes the same procedure for these types of operations, especially those more closely connected to the Bank's developmental mandate and particular constituency's agendas. OVE considers that either of these practices is feasible. However, performance in this area should be monitored over time in order to adapt the Bank's approach to the evolving needs.
- 2.49 **Assessment:** The Bank's general procedures are applied to all types of operations. Since this approach has proven to be adequate for the Bank, OVE finds this principle to be **largely compliant with principle 7.**
- 2.50 **Recommendation:** **Monitor the Bank's treatment of exceptions and ensure that current or proposed procedures adequately mitigate the current risks.** Management has not defined specialized procedures for the treatment of exceptional cases in order to discourage this type of operations. OVE considers that this approach could be appropriate for the current circumstances but recommends this to be reassessed over time on the basis of the Bank's performance vis-a-vis this type of operations.

### C. CREDIT ADMINISTRATION, MEASUREMENT AND MONITORING PROCESS

- 2.51 Principles 8 through 13 (shown in Box 3.3) list the elements of a sound credit administration process: a strong risk governance framework, knowledgeable and experienced human resources, efficient information systems, and effective internal controls.

#### **Box 3.3: Credit Administration, Measurement and Monitoring Process**

- ✓ **Principle 8:** Banks should have in place a system for the ongoing administration of their various credit risk-bearing portfolios.
- ✓ **Principle 9:** Banks must have in place a system for monitoring the condition of individual credits, including determining the adequacy of provisions and reserves.
- ✓ **Principle 10:** Banks are encouraged to develop and utilize an internal risk rating system in managing credit risk. The rating system should be consistent with the nature, size and complexity of a bank's activities.
- ✓ **Principle 11:** Banks must have information systems and analytical techniques that enable management to measure the credit risk inherent in all on- and off-balance sheet activities. The management information system should provide adequate information on the composition of the credit portfolio, including identification of any concentrations of risk.
- ✓ **Principle 12:** Banks must have in place a system for monitoring the overall composition and quality of the credit portfolio.
- ✓ **Principle 13:** Banks should take into consideration potential future changes in economic conditions when assessing individual credits and their credit portfolios, and should assess their credit risk exposures under stressful conditions.



- 2.52 To adequately protect the institution's interests, once a loan has been granted, it has to be placed under active administration. To this end, the institution must ensure it has the borrower's current financial and non-financial information, it can execute a timely follow-up on covenants' compliance and continuously verify the quality and coverage of pledged collaterals. Information management is fundamental for these tasks. An assigned officer needs to have access and update the borrower's financial information, changing conditions in management, market conditions and covenants' compliance. This is essential to the borrower's timely risk assessment, securing the quality of the operation and the portfolio and, whenever called for, the implementation of administrative actions or even recovery procedures.
- 2.53 Additionally, a proper separation of duties between the originating area, risk management, credit administration and loan portfolio management is essential for sound risk management. Such specialization is also an effective complement to the organization's internal controls. Adequate information systems and a sound operational framework - including strong internal controls, loan/guarantee monitoring and rating as well as regular quality analysis- allow scenario analysis, stress tests or other risk sensitivity activities to be carried out as part of the portfolio risk assessment. This also gives greater certainty to the institution's provisioning practices, making pricing more efficient and allocating resources in line with perceived risks.

#### **1. Principle 8: Administration of Credit Risk-bearing Portfolios**

- 2.54 The Bank carries out NSG credit administration procedures through its Portfolio Management Unit (PMU), in coordination with RMG, LEG, OMJ and SCF. Part of these procedures – the operation approval process - was assessed by AUG in May 2009.<sup>23</sup> AUG made twenty seven suggestions regarding the independence of decision making processes, the pricing methodology, access and confidentiality of loan/guarantees information. Management has made significant progress in implementing these recommendations. However, as it was pointed out before regarding the information systems, the Bank still keeps manual procedures and manages key data in relatively isolated information systems.<sup>24</sup> Indeed, if data cannot be timely updated and monitored, the credit administration and analysis functions are limited in their capacity to timely identify deteriorating loans/guarantees. A problem that will be aggravated as the number of operations in the portfolio grows.
- 2.55 **Assessment:** As observed by AUG, the current credit administration processes perform the expected functions, despite a weak support by the Bank's current information systems. Aware of these issues, the Bank is planning a significant transformation and integration of its information systems (mostly via the implementation of the Optima initiative) that is expected to improve this situation over the coming years. On this basis, the Bank is **largely compliant with principle 8.**
- 2.56 **Recommendation:** **As the NSG portfolio is expected to grow significantly, the Bank should fast-track the integration of manual and stand-alone information systems into a portfolio oriented management system.** Such integration would not only increase the efficiency with which loans/guarantees are managed, but it would also facilitate a timely identification of problems to avoid exposing the Bank to excessive risks. This portfolio management system will have to facilitate the provision of timely financial information on borrowers, an effective follow-up of covenants' compliance and enhance assurances on the quality of pledged collateral as an alternative source of repayment.

## 2. Principle 9: Credit Assessment, Classification and Provisioning

- 2.57 RMG is charged with the overall management of credit risk; while PMU is responsible for loan/guarantee administration. This segregation of duties provides an adequate level of independence between operation administration and risk rating. Under this arrangement, SCF or OMJ performs loan/guarantee classification and rating functions and RMG reviews and validates the classification. Both are done with the support of CRCS: a system that assesses three dimensions of loan/guarantee operations and rates them into eight possible risk categories. For this note, OVE assessed and benchmarked CRCS against an industry-accepted rating tool, concluding that CRCS is a robust system for the analysis of individual operations, their classification and corresponding allocation of loan loss reserves.<sup>25</sup>
- 2.58 Project Supervision Reports (PSR) - prepared annually for performing operations (rating RC-5 and lower) and quarterly for higher risk operations (RC-5 on up) - complement the risk monitoring and credit rating functions. These detailed reports allow an adequate understanding of the financial conditions of the borrower, the compliance with the operations' covenants and special monitoring conditions aimed at protecting the Bank's interests. However, the timing of these reports - annually or quarterly – according to the rating of the operation could be revisited as the portfolio grows. The latter would help the Bank more promptly identify deteriorating operations and trigger the corresponding monitoring or resolution actions.
- 2.59 **Assessment:** The independence with which the IDB manages credit files and credit risk, along with its system to report on project status and use of the CRCS, provide adequate assurance that credit and guarantee operations are being adequately assessed, classified and provisioned. Thus, the Bank is **largely compliant with principle 9**.
- 2.60 **Recommendation:** Consider revising the timing of PSRs, from regularly-timed to through-the-cycle reviews. Regularly-timed reviews may not be sufficient to allow a timely identification of rapidly deteriorating loan/guarantees. An alternative “through the cycle” approach - supported by a more robust information system - may be more effective, as the Bank's portfolio grows in size and complexity

## 3. Principle 10: Internal Risk Rating System

- 2.61 CRCS stands at the core of the Bank's system of risk metrics for the NSG portfolio. CRCS is a customized, internally developed system, which integrates borrower (project, structured, and corporate finance, sub-nationals, financial institutions, and OMJ), transaction and country risks. All these three factors are being currently assessed and given appropriate weights in credit ratings. Exceptions and/or issues, as well as any comment submitted by RMG, can be recorded on the CRCS form sheet.
- 2.62 CRCS provides a considerable level of granularity, consistent with rating systems used in the banking industry. It includes: RC-1(excellent), RC-2 (very strong), RC-3 (strong), RC-4 (satisfactory), RC-5 (fair), RC-6 (weak), RC-7 (possible default), and RC-8 (impaired). To track deterioration of the credit portfolio, management has established watch list monitoring procedures for any operation with an RC-6, RC-7 or RC-8 rating.
- 2.63 **Assessment:** The current CRCS is an adequate, fully functional tool that provides comprehensive information about clients and transactions. This system allows the Bank to classify and provision loan/guarantee operations. Even though it does not include the traditional substandard or non-performing categories used in the private banking industry, its eight levels

along with the managerial processes in place are adequate. Therefore, the Bank is **materially compliant with principle 10.**

- 2.64 **Recommendation: Further develop CRCS' capabilities and management to allow for an integrated, more continuous monitoring process.** Currently, the manual introduction of some information into the system exposes it to human error. This could be mitigated by the implementation of an integrated loan/guarantee management system within the context of the previously mentioned IT platform.

#### **4. Principle 11: Information Systems and Analytical Techniques**

- 2.65 The Bank lacks an integrated information system capable of real-time portfolio level analysis and management. The current credit risk management and procedures are designed to provide assurances on the quality of operations in the portfolio at a given point in time (quarterly or annually). By contrast, an integrated system could assist officers to better track the structure, quality and risks of individual operations and of the overall portfolio. Similarly, the ongoing risk classification and rating system is sufficiently robust to track exposures and support loan loss provisions. However, given that it is not automated, as the portfolio grows in size and complexity over time, it might be prone to errors.
- 2.66 The Non-Accrual and Loss Provisioning Committee (NARC) is of the following functions: (i) assessing the accrual or impairment status of specific private sector operations; (ii) assessing the appropriate level of individual and collective loss allowances and write-offs of the Bank's NSG portfolio; (iii) examining the clearance of policies/procedures related to accrual and/or loss provisioning practices prior to their submission for consideration to the Finance Committee; (iv) performing the collective provisioning calculations.<sup>26</sup>
- 2.67 The NARC Committee plays an important role in supporting the Bank's oversight function of non-accrual operations. Although the NARC does not perform portfolio management functions, some of its practices such as watch list reviews currently have portfolio connotations. Therefore, in practice, the NARC adds an additional layer of portfolio quality monitoring. An independent and integrated portfolio monitoring is indispensable for properly engaging in non-sovereign guaranteed operations. Therefore, it is advisable to strengthen a portfolio management function in order to complement the work performed by PMU's credit and loan administration and RMG's risk management functions.
- 2.68 **Assessment:** Current procedures provide basic assurances of the quality of the operations and adequacy of provisions to date. However, the Bank needs to further strengthen its portfolio management function to complement its loan/guarantee administration and risk assessment functions. It is indispensable to formally establish and further develop a proactive portfolio management function. Allocation of resources to further develop existing knowledge and capabilities to perform independent portfolio monitoring responsibilities can be done in a gradual manner. The Bank should also give first priority to the development or outsourcing of an integrated information system. Due to the relevance of these shortcomings, the Bank is currently **materially non-compliant with principle 11.**
- 2.69 **Recommendation: Strengthen the Bank's portfolio management function.** As noted, there is no management of the credit portfolio, in a way that could help the Bank actively gauge the overall risk being incurred in its NSG operations. Potential losses due to the absence or low capability of existing information systems justify a high prioritization of the required IT

resources. Integrated, accurate and most importantly, timely processing of data and reporting of information related to private sector operations is an essential management tool.

## 5. Principle 12: Credit Portfolio Monitoring System

- 2.70 The Bank's systems and procedures are capable of monitoring the composition and quality of the various loan/guarantee operations individually. However, as repeatedly mentioned before, the Bank lacks a system to integrate individual data at the portfolio level. Currently, portfolio level monitoring is cumbersome, as data aggregation and operations' knowledge need to be collected from different sources, normalized and interpreted. An integrated information system would not only increase robustness by diminishing the reliance on manual aggregation, but also allow the analysis of operations at the individual and aggregate levels on a continuous basis.
- 2.71 In a context in which the Bank is seeking to modify its concentration policy, the weakness of the Bank's current systems and procedures could lead it to over-react with mitigating measures aimed at managing sector or country concentrations. By contrast, having portfolio level monitoring, complemented by a concentration policy and adequate information systems, could help the Bank to more timely identify problems and adopt proper measures to manage them.
- 2.72 **Assessment:** The absence of a robust system to monitor the portfolio with the support of an integrated information system makes the Bank **materially non-compliant with Principle 12.**
- 2.73 **Recommendation: Streamline the development, or the outsourcing, of an integrated information system capable of tracking portfolio composition and quality in real time.** The lack of the integrated system, as it was repeatedly mentioned before, also affects compliance with this principle.

## 6. Principle 13: Scenario Analysis and Stress Tests

- 2.74 CRCS, along with the described procedures, is an adequate tool to support the Bank's capital commitment adequacy and provisioning levels for its NSG operations. However, due to the absence of a more active portfolio level management, there is no evidence of the Bank's conducting scenario or stress tests. These portfolio-level tests are used in the industry to force a forward looking approach to the identification and mitigation of potential risks. They have the virtue to force an institution to take a higher level perspective and explore correlations among operations, as well as underlying causes of risks that may affect seemingly unrelated ones.
- 2.75 Analyses of the reports issued by SCF, provide sufficient information regarding the health of NSG operations and actions being taken when they are rated RC-5 on up. However, there is no reporting on the general quality of the portfolio, its structure, cost, concentration levels and inherent risks. Fortunately, due to its current size and the operating practices, the portfolio has not found itself in need for contingency plans to control potential exposure threats.
- 2.76 **Assessment:** The Bank's CRCS loan loss reserve practices fit well with the loan/guarantee analysis and granting process. It also provides sufficient assurance on capital utilization requirements to cover potential risks. However, there is no evidence of the use of other tools, such as stress tests or scenario analyses, customarily used in the industry to support capital utilization requirements or design contingency plans to resolve problem operations that may have a negative impact on the loan/guarantee portfolio. This threat has not yet materialized, given the small size of the NSG portfolio, but as it grows these practices will need to be considered. On this basis, the Bank is currently **materially non-compliant with principle 13.**

2.77 **Recommendation: Consider the implementation of portfolio analytics tools, including stress testing and scenario analysis.** As the Bank’s NSG portfolio grows, it would start placing at risk a more significant portion of the Bank’s capital. Thus, it is advisable that the Bank increases its capabilities and sophistication in the forward-looking assessment of the risks posed at the portfolio level, and the appropriate mitigating measures.

#### **D. Credit Risk Controls**

2.78 An institution’s credit risk controls are built upon its own internal control system. This system aims “to ensure that the goals and objectives of a banking organization will be met, that the bank will achieve long-term profitability targets, and maintain reliable financial and managerial reporting. Such a system can also help to ensure that the bank will comply with laws and regulations as well as policies, plans, internal rules and procedures, and decrease the risk of unexpected losses or damage to the bank’s reputation.”<sup>27</sup>

2.79 The system also requires active involvement by the board of directors. The board should also make sure that the bank is operating within the expected risk limits, in line with its risk appetite, and demand adjustments if necessary. In turn, management should implement the credit risk framework by issuing and executing appropriate operational guidelines. The specific principles relating to credit risk control are detailed in Box 3.4.

#### **Box 3.4: Credit Risk Controls**

- ✓ **Principle 14:** Banks must establish a system of independent, ongoing assessment of the bank’s credit risk management processes and the results of such reviews should be communicated directly to the board of directors and senior management.
- ✓ **Principle 15:** Banks must ensure that the credit-granting function is being properly managed and that credit exposures are within levels consistent with prudential standards and internal limits. Banks should establish and enforce internal controls and other practices to ensure that exceptions to policies, procedures and limits are reported in a timely manner to the appropriate level of management for action.
- ✓ **Principle 16:** Banks must have a system in place for early remedial action on deteriorating credits, managing problem credits and similar workout situations.

#### **1. Principle 14: Ongoing Independent Assessment**

2.80 In the context of Bank’s annual NSG portfolio review, the Board and Senior Management have an opportunity to highlight any issue with the credit risk system. Complementing this review, the quarterly report on NSG operations to the IDB Board of Executive Directors (issued by SCF) provides detailed information to evaluate the performance of the operations and resulting NSG portfolio. This report also provides information on the risks being incurred and the corresponding calculation of loan loss reserves to cover for potential losses.

2.81 In addition, SCF and RMG collaborate in drawing lessons learned from impaired operations. However, there is no established procedure for this lessons learned to be drawn. In some cases special post-mortem reports have been prepared, although not by independent parties. In some other cases, lessons have been drawn more informally in the context of staff meetings. Furthermore, the Board has had the support of AUG to review internal processes. In particular, AUG has conducted independent reviews of the credit risk classification system and process and the NSG approval process.

- 2.82 An important challenge in this respect is the possibility that impaired operations be subject to legal proceedings. In this context, any written lessons learned may be subject to the discovery process, and as such made available to the opposing parties at trial. In this context, any candid recognition of weaknesses regarding the Bank's understanding or processing of the transaction, may be used against the Bank. Similarly, impaired operations that have reached a final settlement stage often commit the Bank to confidentiality that may also prevent dissemination of lessons learned. Accordingly, the Bank needs to find adequate means that balance these potential risks with the need to inform future operations about lessons learned.
- 2.83 **Assessment:** The Board and senior management receive periodic updates on the portfolio, individual operations, as well as the general credit risk profile. However, these assessments are not built as comprehensive reviews of the credit risk management system itself. In theory, OVE also has some complementary functions in this area, but depends on specific requests by the Board of Directors for them to be included in OVE's annual work plan. Thus because the Bank still lacks an organic, internal mechanism to systematically test its credit risk management system and communicate the results directly to the Board, the Bank is **largely non-compliant with principle 14.**
- 2.84 **Recommendation:** **Develop a mechanism, strongly supported by management, to systematically test the Bank's credit management system and periodically communicate the results to the Board.** The testing of the credit management system and the drawing of lessons learned needs to become less *ad hoc*, and more of a mainstream activity to be internalized within management's structure. Unfiltered feedback on issues uncovered needs to be directly and periodically communicated to the Board.

## 2. Principle 15: Prudential Standards and Internal Controls

- 2.85 The Bank's organizational and procedural framework and the internal controls overseen by the Board have allowed the Bank to operate within reasonable risk levels. In addition, the CRCS has allowed an adequate control of the Bank's risk tolerance. Nevertheless, the **development of a Credit Risk Framework** (that would make more explicit the Bank's risk appetite, not just its risk tolerance), the **strengthening of a portfolio management function** and a **solution to the information management issues** would help round up the Bank's risk control processes.
- 2.86 So far, the internal audit function (AUG) has effectively identified the challenges facing the organization to further strengthen its credit risk management. However, **audits are planned on a risk based approach and not based on the business cycle. In addition, audits are not an integral part on the internal controls and are not designed to monitor the ongoing credit risk management.** In addition, exceptions to policies, procedures and limits are handled ad-hoc. This has created significant challenges to management that had to learn-by-doing when a particular operation did not fit established guidelines, but was nevertheless pursued for developmental or political reasons. Had exception procedures been established before-hand, responsibilities and expectations would have been more clearly assigned, including those pertaining to the Board itself.
- 2.87 **Assessment:** The audit reports and the work of SCF and RMG have effectively addressed the challenges presented by the loan/guarantee administration processes; allowing the development of the required policies and procedures. Thus, IDB is **largely compliant with principle 15.**

2.88 **Recommendation:** Consider creating a process improvement function to support the Bank's credit risk control framework. As SCF's operations multiply in number and complexity, the task of ensuring the soundness of the credit risk management system would require a specialized functionality. The opportunities identified by this Note regarding the Credit Risk Framework and the Integrated Information System are examples of ongoing challenges the Bank's internal control environment would face as it evolves.

### 3. Principle 16: Early Warning and Problem Loan Management

2.89 The early warning system of the Bank has two key components: the Watch List Procedures and the portfolio management function. Operations with a rating of RC6, RC7 or RC8 are automatically placed under watch list surveillance and subject to periodic Watch List Reviews. In the context of the NARC there are also quarterly discussions of problem operations; and a definition of whether these operations should become part of a preventative watch list or go directly through a recovery process. There is evidence that NARC has so far timely acted in cases where one operation became problematic. A Special Assets Unit (SAU) follows up on problem operations. This workout unit (SAU) is sufficiently experienced and provides important input to the restructuring process. Accordingly, SAU has so far performed adequately, a fact that is consistent with the quality of the current NSG portfolio.

2.90 **Assessment:** The Bank current system to manage problem loans and guarantees has proven effective; as evidenced by the quality of the current portfolio, as well as by the adequate handling of problem operations at the level and size of the current portfolio. Thus, the Bank is largely compliant with principle 16.

2.91 **Recommendation:** Consider strengthening the early warning and watch list mechanisms. The Bank has put in place the different elements of a system to provide Early Warning and Problem Loan Management. However, in the context of the previously recommended strengthening of the portfolio management function, the Bank should also consider to further institutionalize watch list procedures. This may include a more regular scheduling of watch list meetings.

### E. Supervisory Framework

2.92 Principle 17 addresses the role of a supervisory framework. This principle is universally accepted in commercial banking, where some sort of banking superintendence usually performs this important function. The principle requires a bank to be subject to "an effective system in order to identify, measure, monitor and control credit risk as part of an overall approach to risk management". To this end, an independent supervisory function conducts periodic evaluations of a bank's strategies, policies, procedures and practices related to the granting of credit and the ongoing management of the resulting portfolio. Furthermore, this function has the capability to issue risk mitigation directives, such as setting prudential limits or restricting bank exposures.

2.93 As an international organization, the IDB is in principle not subject to any specific supervisory entity. Governors, and by delegation the Board of Executive Directors, currently exercise these supervisory responsibilities as far as they were originally intended by the Bank's member countries. However, this has led to an arrangement where shareholders (via its Board) exercise both credit approval and supervisory responsibilities. This is certainly not the practice in the industry, where these functions are clearly separated to avoid conflicts of interest. Although not required, a potential separation of these functions would reinforce the governance of the Bank.

- 2.94 For this function to be effective, it would need to have unfettered access to all information pertinent to the loan/guarantee granting, administration and management processes. Although independent, the supervisory function could coordinate its work plan with management's own review activities. Such coordination is critical to avoid duplications with respect to the evaluation of the quality of the loan/guarantee portfolio, the sufficiency of the internal control environment, the efficiency of the Bank's capital use or the adequacy of provisions. Risk assessment and monitoring functions would also have to be evaluated on an ongoing basis. This is especially important regarding problem operations; sector/country; concentrations; portfolio trend analyses; adequacy of the provisions and capital utilization.
- 2.95 **Assessment:** Given the special institutional arrangement of the Bank, technically it is subject to no supervisory authority, thus **no assessment corresponds in relation to principle 17.**
- 2.96 **Recommendation: Consider implementing an ongoing, supervisory process to further support SCF, OMJ, RMG and the Board in the identification, measurement and monitoring of risks, as well as to reinforce its governance structure vis a vis NSG operations.** The Bank should assess the cost-benefit trade-offs of securing the availability of some basic supervisory framework to complement governance in connection with the Bank's NSG exposure. Such framework could be implemented either throughout the current Bank's organizational structure –including any potential role within OVE current mandate- or the external services of specialized panel of consultants.

### III. ASSESSMENT OF THE RISK CLASSIFICATION SYSTEM

- 3.1 A credit risk classification and rating system is essential for the management of credit risk in any banking organization. Such system is meant to be the common pillar underlying all the different components of a credit risk management system; able to keep bank management and the Board aware of risk exposures at both individual and portfolio levels. Due to its key relevance, OVE placed particular emphasis on evaluating the risk classification system in place at the Bank (known as CRCS). OVE engaged a senior consultant who re-assessed 100% of operations in SCF's portfolio with the following objectives: (i) determine the quality of these assets; (ii) confirm compliance with Bank financial and operating policies; (iii) confirm compliance with loan covenants and conditions; and (iv) highlight any portfolio concentration.
- 3.2 OVE found CRCS to be comprehensive and useful to the Bank. To issue this opinion, OVE carried out an extensive interaction with management and SCF officers, as well as senior officials outside of SCF. Based on these on site observation and the information developed on the portfolio and credit procedures, OVE concludes that the Bank currently has a loan and guarantee's portfolio that fits within the parameters expected in an organization with a sound credit management system. The portfolio condition is good, in absolute and comparative terms. For the most part clients fit risk categories RC-2 through RC-4, with several RC-1 and RC-8. Such can be described as a normal portfolio distribution. There are about ten RC-5 and RC-6 cases, which are of concern, but which are being closely supervised by management.
- 3.3 In 43.5% of the cases reviewed there was a difference between CRCS and OVE rating levels; but this difference was expected, and in fact served to verify CRCS's soundness. For the most part, variations were due to a difference in the rating methodology. To avoid any potential bias,



OVE focused on only one of the key credit risk dimensions (borrower strength), and excluded from its review other dimensions such as transaction/structuring or country environment. This was done only for the purpose of assessing the robustness of the Bank's rating system, in order not to obscure comparisons by combining the potentially offsetting effects of the different dimensions affecting credit risk. OVE found that for corporate and project finance, 11 operations had a better OVE rating and 10 a worse rating. For TFFP transactions, 5 had a better OVE rating and 4 a worse one than the one assigned by CRCS. This almost equal number of projects being shifted one way or the other indicates that CRCS is a balanced system, without any perceivable distortion. \

- 3.4 The analysis also uncovered portfolio concentration issues: (i) Brazil represented at that time 35% of the total portfolio, followed by Peru with 15%, (ii) energy production and distribution represented 22% of the total portfolio, and, most importantly, (iii) the ten largest clients comprised 50% of the total NSG lending portfolio. These levels of concentration were high by industry standards and merit further policy analysis and mitigating measures, as suggested in the prior chapter. In this regard, the recently approved NSG Concentration Limits introduces a framework within which a higher diversification could take place. As mentioned before, the Bank also needs to strengthen its portfolio management function and develop or outsource an information management system, able to operate continuously to support management's decision making. Finally, as CRCS evolves it should strive to maintain its current, adequate balance between quantitative and qualitative rating criteria.

## IV. CONCLUSIONS AND RECOMMENDATIONS

### A. Conclusions

- 4.1 As mentioned before, the IDB is not required to adhere to the credit risk management principles issued by the Basel Committee. Yet, these principles provide an industry- accepted benchmark to assess an organization's readiness for managing credit risk. Against that benchmark, OVE found **generally positive results**: the Bank materially or largely complies with 12 of the 17 principles. Out of the remaining ones, the Bank still materially or largely not complies with four principles (especially in the area of credit administration and monitoring). Lastly, one principle is strictly non-applicable because the IDB is not subject to any independent supervisory entity. In this context, the review highlights several areas of opportunity for the Bank to further develop what already is a **solid foundation for its credit risk management system**. The most relevant of these areas are described below, followed by a section on recommendations.

**Table 5.1 – Summary Assessment and Recommendations**

| Principle |                                      | OVE Assessment <sup>28</sup> |     |    |    | Recommendation  |
|-----------|--------------------------------------|------------------------------|-----|----|----|---|
|           |                                      | MNC                          | LNC | LC | MC |   |
| 1         | Credit Risk Environment              |                              |     | X  |    | Develop a Credit Risk Framework based on a definition of Bank’s risk appetite                         |
| 2         | Policies and Procedures              |                              |     | X  |    | Optimize the specificity and consistency of policies and procedures.                                  |
| 3         | Product and Activity Risk            |                              |     | X  |    | Develop guidance for collecting lessons learned from new groups of approved operations.               |
| 4         | Credit Granting Criteria             |                              |     | X  |    | Specialize Due Diligence Procedures - Further clarify engagement with RMG                             |
| 5         | Credit Limits                        |                              |     |    | X  | Ensure implementation of the established concentration limits.  |
| 6         | Approval Procedures                  |                              |     |    | X  | Continue improving the timing and frequency of interactions between VPP (SCF or OMJ manager) and RMG. |
| 7         | Exceptions and Related Parties       |                              |     | X  |    | Monitor treatment of exceptions and ensure adequate risk mitigation.                                  |
| 8         | Portfolio Administration             |                              |     | X  |    | Integrate manual / stand-alone tasks into Portfolio Management IT System                              |
| 9         | Credit Monitoring                    |                              |     | X  |    | Convert PSRs, from regularly-timed to through-the-cycle reviews.                                      |
| 10        | Risk-Rating System                   |                              |     |    | X  | Enhance CRCS’ capabilities to allow for integrated, continuous monitoring                             |
| 11        | IT and Analytical Techniques         | X                            |     |    |    | Strengthen the Bank’s Portfolio Management function.  |
| 12        | Portfolio Monitoring                 | X                            |     |    |    | Develop Integrated Portfolio IT system to continuously track risk                                     |
| 13        | Scenario Analyses and Stress Testing | X                            |     |    |    | Implement Portfolio Analytics Tools, e.g., stress testing & scenario analysis.                        |
| 14        | Independent Assessment               |                              | X   |    |    | Independently and periodically test credit system and report to the Board                             |
| 15        | Prudential Standards/Controls        |                              |     | X  |    | Create a Process Improvement Function to support the Bank’s credit risk controls                      |
| 16        | Early Warning and Problem Loans      |                              |     | X  |    | Consider strengthening the early warning and watch list mechanisms.                                   |
| 17        | Supervisory Framework                | NA                           | NA  | NA | NA | Consider implementing an ongoing supervisory process to support governance vis-a-vis NSG risk         |

4.2 **The Bank has defined a risk tolerance towards NSG operations, but has yet to define its NSG risk appetite.** Risk tolerances refer to the limits the Bank has placed to be able to absorb

its involvement in NSG operations. By contrast, risk appetite is the proactive expression of the level and type of risk the Bank is willing to embrace in order to pursue its mission via NSG operations. It is important to notice that even within the same risk tolerance, different risk appetites would lead to very different portfolios regarding, for example, types of clients, sectors, tenors and instruments. In turn, these differences should drive the design and management of the most suitable credit risk management system. It's also worth mentioning that the recent NSG and Private Sector Development Strategy Profiles (GN-2598-1, January 2011) still lack the specificity required to constitute an expression of the Bank's risk appetite.

- 4.3 As a consequence, the **Bank has not yet adopted a comprehensive Risk Management Framework**. This creates challenges for credit granting, assessment and management processes. It also affects the Bank's checks and balances among originating units and those responsible for risk assessment and portfolio management. Some progress towards this issue has been materialized with the recent approval of the NSG Concentration Limits. This will contribute towards reducing the Bank's exposure to few sectors, thus ensuring a better diversification.
- 4.4 Despite recent improvements, due diligence procedures still take an average of nine months, raising the prospect of the **Bank being perceived as a somewhat bureaucratic organization, attractive to a riskier pool of clients unable to secure alternative funding**. Issues, such as uncertainty over social and environmental requirements (especially in new sectors or types of operations) has been mentioned as the driver of a recent spike in delays and cancellations. The Bank operates under a generic, standardized procedure that is also applied to new types of operations/sectors, as well as to potential exceptions. Although this differs from the common practice at private financial institutions, management considers this is an appropriate approach for the Bank.
- 4.5 The review also finds that the **Bank has made good progress by creating RMG, but it has yet to define clearer rules for RMG's engagement during the loan/guarantee assessment process**. Lack of pre-defined procedures and checklist clarifying RMG typical participation along the life-cycle of an operation have led to some inefficiency in credit origination, as well as a reduced ability to proactively engage RMG in on-going credit monitoring activities. Currently, NSG management and RMG are making progress towards reaching these working agreements but additional integration is required in this area to strengthen the credit risk management assessment and portfolio management of NSG transactions.
- 4.6 In reference to credit administration, measurement and monitoring; **the Bank still utilizes stand-alone systems and manual procedures that may pose risks as the portfolio grows in size and complexity**. The lack of an integrated IT portfolio management system places unnecessary risks on the integrity of the loan/guarantee granting process, the timely detection of problem operations, and the ability to assess the robustness of its loan/guarantee portfolio.
- 4.7 The review finds that **CRCS is an adequate tool supporting the credit assessment, classification and provisioning**. In addition, this system permits a considerable level of granularity through its eight classification categories. However, the **CRCS system does not allow for a continuous integration of data at the portfolio level**. Such integration could contribute towards a more efficient management of the Bank's capital utilization, pricing and portfolio structure based on the risks, as well as a more proactive management of the portfolio.

- 4.8 **The Bank’s PMU effectively discharges some monitoring responsibilities, but falls short of those required for a proactive management of the portfolio.** PMU mostly discharges loan/guarantee administration duties at the individual operation level, but it’s charged with limited portfolio management duties. Similarly, the NARC has some responsibilities over problem operations, and some focus on policy and institutional issues related to them. However, detailed guidelines and policies are still not comprehensive.
- 4.9 **The Bank’s practice of reviewing performing operations on an annual basis, and problem-operations quarterly is still adequate for the current size of the portfolio.** However, a “through the cycle” review process would be better able to fine-tune portfolio quality in line with the Bank’s risk strategy and risk appetite. This capability would require the strengthening of the portfolio management function and the implementation of an integrated portfolio management information system.

## **B. Recommendations**

- 4.10 **Recommendation 1: Develop an explicit Credit Risk Framework:** So far the Bank has approached its interactions with NSG operations in terms of its risk tolerance to potential losses. The Governors have gradually increased this risk tolerance over time, culminating with the recent provisions in IDB-9. These increased levels of exposure make it clear that, going forward, the Bank would need to transition from its implicit risk tolerance policy, towards a more explicit risk-appetite-based policy. This proactive definition of the specific types of risks the Bank is willing and able to incur should be articulated within a comprehensive Credit Risk Framework, specific enough to drive the Bank's risk culture and NSG operations. Such framework would be expected to define: (i) the risk management approach and objectives; (ii) the expected quality of the credit portfolio; (iii) underwriting standards; (iv) credit limits per type of operation and borrower; (v) specific economic sectors the Bank is better prepared to support; (vi) concentration limits per operation, economic sector, and their interaction; (vii) the products and services offered and their corresponding risk limits; (viii) replicable, objective mechanisms to set a risk based pricing; (ix) the credit rating system and the limits established for each rating; and (x) the underwriting exception triggers. Finally, provisions need to be made to review limits and objectives periodically, and make them compatible with NSG Strategy.
- 4.11 **Recommendation 2: Further map-out the interactions among the different areas with the support of an integrated IT system:** Most NSG processes are still conducted manually, or rely on isolated systems. This modus operandi was appropriate when the Bank had a small NSG portfolio. But now, the Bank’s NSG business has reached a volume that requires standardization to avoid the risks posed by different interpretations. Until now, operational guidelines were mostly communicated to staff via internal paper memoranda. Going forward, it is recommended that the Bank integrates the NSG rules and procedures into an IT system to facilitate staff’s quick review of compliance items and the consistent implementation of procedures. In line with the prior recommendation, the system would need to support clear due diligence guidelines per type of operation and borrower, describe the risk classification and monitoring processes and clearly identify the established internal controls for credit administration, collateral management, the workout of problem operations and the treatment of exceptions. The system would also need to integrate guidelines with the key requirements each type of operation will need to meet from an environmental and social safeguards standpoint. The system should also help to further clarify the interactions of SCF, OMJ and RMG during the loan and guarantee granting process. However, given that IT implementation usually takes

time, OVE suggests proceeding immediately with the mapping-out of the respective interactions, prior to automating them using the integrated IT system.

- 4.12 **Recommendation 3: Strengthen the Portfolio Management Function:** Currently, PMU performs the *credit administration* function, and as a small sub-component, PMU also discharges basic *portfolio management functions*. Both the *credit administration* and *portfolio management functions* are integrated with the *origination and structuring functions* (discharged by SCF and OMJ). By contrast, the *risk management function* (undertaken by RMG) is deemed to be sufficiently independent. Therefore, it is recommended to strengthen the *portfolio management function* under a procedural framework that guarantees its independence from the *origination and structuring functions*. Benefits of a stronger portfolio management function include, among others, the ability to structure a higher quality loan/guarantee portfolio, and the possibility of reinforcing risk-based pricing practices for NSG clients. It is also recommended that as part of its strengthening, the **Bank incorporates a module geared towards supporting its portfolio risk management function into the previously suggested IT system**. The system should be able to manage operational, financial and risk classification data, as well as facilitate the proper filing, custody and management of each operation's information; including those that the Bank declined to support at the time. The system would also facilitate a transition from a point in time - annually or quarterly - to a "through the cycle" operational assessment process; as well as portfolio analytics tools, such as scenario analysis and stress tests. Finally, the institutionalization of NSG portfolio periodic stress testing exercises, portfolio management discussions and watch-list meetings is recommended to be implemented in the short-term, even before the full implementation of the IT system.
- 4.13 **Recommendation 4: Consider implementing an ongoing, supervisory process to further support SCF, OMJ, RMG and the Board in the identification, measurement and monitoring of risks, as well as to reinforce its governance structure vis a vis NSG operations.** The Board and senior management receive periodic updates on the portfolio, individual operations, as well as the general credit risk profile. However, these assessments are not comprehensive reviews of the credit risk management system itself. Thus it's recommended that the Bank *build an organic, internal mechanism to systematically test its credit risk management system and communicate the results directly to the Board*. This would allow the testing of the credit management system and the drawing of lessons learned to become less ad-hoc, and more of a mainstream activity to be internalized within management's structure. Unfiltered feedback on the issues uncovered needs to be directly and periodically communicated to the Board. In addition, as an international organization, the IDB is in principle not subject to any specific supervisory entity. However, this has led to an arrangement where shareholders (via its Board) exercise both credit approval and supervisory responsibilities; a practice avoided by the industry, where these functions are clearly separated to prevent conflicts of interest. In this regard, the Bank should assess the cost-benefit trade-offs of securing the availability of some basic supervisory framework to complement governance in connection with the Bank's NSG exposure. Such framework could be implemented either throughout the current Bank's organizational structure - including any potential role within OVE current mandate - or the external services of specialized panel of consultants.
- 4.14 **Recommendation 5: Monitor performance of New Types of Sectors & Operations and Exceptions to ensure that the current, generic procedures adequately fit their risk profile:** The Bank currently conducts its NSG business under the guidance of fairly generic procedures.

With the current portfolio composition, this approach still doesn't pose large risks. As the Bank diversifies its NSG operations, this generic approach may eventually underutilize potential lessons learned about typical risks faced in new sectors and types of operations. Similarly, given the Bank's developmental objective decision making processes are regularly exposed to exceptions from strict financial considerations. Thus, it is recommended that the Bank periodically reassesses the continued adequacy of the current practice of not counting with a specialized procedure for exceptions.

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## Endnotes

1 AB-2764: Report of the Ninth General Increase in the Resources of the IDB

2 GN-2547-2: Risk taxonomy and tools.

3 Currently the Bank's PMU unit carries out functions referred to loan/guarantee administration but it does not address anything but basic portfolio management functions. The Non-Accrual and Loss Provisioning review Committee (NARC) also mobilizes some ad-hoc discussions at the portfolio level (although Portfolio Management is not included in its functions). Portfolio management functions would be beneficial in securing a high quality loan/guarantee portfolio, support the Bank's risk based capital utilization, and help improve the Bank's pricing mechanisms.

4 Selection of sample was made jointly with SCF to include, as of 12/31/2008: (a) all A loans which had begun disbursing and had an outstanding balance; (b) all project/credit guarantees for which the IDB had had exposure as of the established date, and all Trade Finance Facility Programs (TFFP) as of 12/31/2008 under which exposure had incurred or had exposure at that point (revolving lines). Loans and guaranteed which had been paid off or the exposure considered extinguished (i.e. special assets projects) and OMJ projects were not reviewed.

5 Basel Committee on Banking Supervision; Core Principles Methodology, 2006.

6 Mr. Martin Naranjo, Mr. Bruce Nichols, and Mr. Rudy V. Araujo; former Superintendents of Banks and/or credit risk experts in the banking industry.

CAMEL refers in general terms to an assessment system often used by banking supervisors that evaluates an institution's Capital, Assets, Management, Earnings and Liquidity.

8 Credit Assessment refers to the origination, eligibility and due diligence of a potential loan whilst Credit Risk Management considers the assessment of the risks to be incurred in the loan, its structuring, granting and ongoing administration.

9 GN-2597: NSG Concentration Limits.

10 The Auditor General's report GN-2547 identified the absence of an integral risk management framework.

11 AB-2764 Report on the Ninth General Increase in the Resources of the IDB; GN-2547-2: Risk taxonomy and tools; NSG Operating Guidelines, GN-2597: NSG Concentration Limits.

12 As per December 2008, 72% or \$2.62 billion of SCF's loan portfolio was concentrated in four countries and 34.41% or \$1.26 billion was concentrated in three economic sectors.

13 As of December 2008, 76% of the loan portfolio was concentrated in gas and fuels, energy distribution and transportation, financial markets and institutions, transportation infrastructure and communications. Projects in the portfolio had the technical support of external experts during loan structuring but not necessarily during its management and, most importantly, periodic credit rating.

14 RMG was assigned this responsibility through Resolution DE-162/06. The Office of Risk Management is in charge of managing risk within the organization, including the assessment of credit, operational and market risks. RMG is responsible for strengthening the Bank's capacity to identify, measure and manage the credit risks of the Bank in non-sovereign guaranteed loan portfolio, and its treasury activities including derivatives.

15 CRCS is an 8-grade (RC-1 through RC-8) rating system implemented in 2009

16 Notice that risk tolerance and risk appetite are not used as synonymous.

17 Agreement Establishing the Inter-American Development Bank, Article I, Section 2.

18 Indeed a recent Audit Report: TFFP – Operations and Systems, highlights the risk that “unclear price monitoring process and inaccurate information could lead to non-compliance of transaction and portfolio level limits established by Management and/or Board. In addition, inadequate system access controls could result in lack of accountability of actions and unauthorized changes of transaction terms”. Accordingly, the Report recommends, among others, to review then methodology used to calculate the NSG net spread income differential in the NSG quarterly reports, so that the "net loan interest NSG spread" and the "SG Board approved average loan interest spread" are based on the same time period.

19 See paragraph 4.3 of the IDB's Operational Guidelines for Non-Sovereign Guaranteed Operations.

20 See paragraph 4.4 of the IDB's Operational Guidelines for Non-Sovereign Guaranteed Operations.

21 See paragraph 4.6 of the IDB's Operational Guidelines for Non-Sovereign Guaranteed Operations.

22 IDB, AXS Loan Analysis, December 2009, PR-2707-5

23 Internal Audit Report: NSG Operations Approval Process, May 2009.

24 Ibid.

25 See Section IV and Annex II for the detail regarding this assessment.

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As stated on quarterly reports on Non-Sovereign Guaranteed Operations to the Board of Directors.

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Basle Committee on Banking Supervision, Framework for Internal Control Systems in Banking Organizations, Basel, September 1998

28

MNC = Materially Non-Compliant; LNC = Largely Non-Compliant; LC = Largely Compliant; MC = Materially Compliant; NA = Not-Applicable.