Risk Management Policies and Processes

Introduction

The African Development Bank has established and executes various policies and procedures to reduce or limit exposure to risks assumed in the normal course of providing development banking services. Such policies and processes reduce the Bank’s exposure to interest rate, currency, liquidity, legal, and operational risks, while maximizing its capacity to assume the risks of extending credit to its public sector and private sector clients within its approved risk limits.

1 Public Sector Credit Risk

The single largest source of risk for the Bank is the potential default of its public sector borrowers. In addition to its preferred creditor status, the Bank’s approach to managing this credit risk includes a rigorous assessment of the default risk of its borrowing member countries through an annual country rating exercise that classifies such borrowing member countries on a five-point internal credit risk rating scale. The ratings are then used to determine the maximum sustainable credit ceilings for the member countries eligible to borrow from the ADB window.

The Bank maintains a prudent distribution of its public sector portfolio through its exposure management policies. For each eligible public sector borrower, the Bank applies an exposure limit that reflects the country’s risk rating and its economic potential subject to a maximum loan equivalent exposure for any single country that is not more than 15% of the Bank’s maximum sustainable portfolio. The country exposure limits are reviewed annually and are used as a risk-based benchmark to plan the Bank’s medium-term country assistance strategies.

It is the Bank’s policy that if a payment of principal, interest or other charges with respect to an ADB or ADF loan becomes 30 days overdue, no new loans to that member country, or to any public sector borrower in that country will be approved, nor will any previously approved loan be signed, until all arrears are cleared. In addition, disbursements on all loans to or guaranteed by that member country are suspended until all overdue amounts have been paid. Further, for qualifying loans, the granting of commitment fee waivers of 0.50% on the undisbursed balances is contingent upon satisfactory payment performance.

Further, the Bank makes a general provision for the expected losses in its public sector portfolio that reflects its assessment of the collectibility risk inherent in the portfolio. In recognition of the estimated portfolio collectibility risk in 2000, the Bank increased the accumulative general provisioning rate as a percentage of the total disbursed and outstanding public sector loans from 5.5% in 1999 to 6.25% in 2000.

To cover potential unexpected credit related losses due to extreme and unpredictable events, the Bank maintains a conservative risk capital cushion for public sector credit risks. The Bank’s capital adequacy policy articulates differentiated risk capital requirements for all public sector credit-sensitive assets (loans and equity investments) plus contingent
liabilities (guarantees and client risk management products) in each risk class. At the end of 2000, the Bank’s public sector portfolio used up approximately 77% of the Bank’s total on-balance sheet risk capital (paid-in capital plus accumulated reserves plus general provisions). The Banks takes a prudent approach to measuring capital adequacy for operational planning and does not include callable capital or subordinated debt in its computation of its risk capital.

2 Private Sector Credit Risk

Another source of risk for the Bank is the potential default of its private sector borrowers. The Bank’s approach to managing this credit risk starts with a rigorous appraisal of new loan proposals and continues with quarterly assessments of the default risk of each outstanding private sector loan. To ensure a prudent distribution of its private sector loan portfolio, the Bank generally limits its exposure in any single project to the lesser of one-third of the total project financing cost or 10 million US Dollars. These limits may be exceptionally waived for large infrastructure projects and investment funds. To partially mitigate the credit risk for direct private sector loans, the Bank generally requires a range of securities and guarantees from the project sponsors.

To cover the expected losses in the performing private sector portfolio (ratings 1 to 6), the Bank makes a general provision between 2% and 15% of the total loan equivalent exposure based on individual project risk ratings. For non-performing projects (ratings 7 to 10), the Bank makes a specific provision based on an assessment of the credit impairment of each project. In addition to lending, the Bank may make equity investments in private sector projects. In cases where the equity investment is assessed as potentially non-performing, the Bank may make a provision based on accepted impairment tests measured against the Bank’s carrying cost. For investment funds in the early stage, the Bank makes provisions in increments of 25% based on an assessment of actual performance versus the Bank’s expectations at the time of approval.

To cover potential unexpected credit related losses due to adverse and unpredictable events, the Bank maintains a conservative risk capital cushion for private sector credit risks. The Bank’s capital adequacy policy articulates differentiated risk capital requirements for all credit sensitive private sector assets (loans and equity investments) plus contingent liabilities (guarantees and client risk management products) in each risk class. At the end of 2000, the Bank’s private sector portfolio used up less than 2% of the Bank’s total on-balance sheet risk capital.

3 Counterparty Credit Risk

In the normal course of its business, the Bank utilizes various financial instruments to meet the needs of its borrowers, to manage its exposure to fluctuations in market interest and currency exchange rates, and to temporarily invest its liquidity prior to disbursement. All of these financial instruments involve, to varying degrees, the risk that the counterparty in the transaction may be unable to meet its obligation to the Bank.

To reflect a preference for minimizing exposure to counterparty credit risk, the Bank maintains eligibility criteria that limit the Bank’s financial operations to counterparties with the very best credit ratings. For example, the minimum rating for counterparties for derivative instruments is AA.
In addition to these stringent rating standards, the Bank operates a framework of exposure limits based on the counterparty credit rating and size subject to a maximum of 10% of the Bank’s total risk capital for any single counterparty. Individual counterparty credit exposures are aggregated across all instruments using the Bank for International Settlements (BIS) potential exposure methodology and monitored regularly against the Bank’s credit limits. As a rule, the Bank executes an International Securities Dealers Association (ISDA) master agreement and netting agreement with its derivative counterparties prior to undertaking any transactions. The estimated potential counterparty credit exposure of the investment and derivative portfolios showed an increase in the share of exposure to AAA credits against a decrease to AA credits during the year.

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<th>Credit Risk Profile of the Investment and Derivative Portfolios</th>
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To protect against potential unexpected credit related losses due to unpredictable adverse events, the Bank maintains a conservative risk capital cushion for counterparty credit risks as per the current BIS standards. At the end of 2000, the Bank’s counterparty credit portfolio required as backing, less than 1% of the Bank’s total on-balance sheet risk capital.

4 \quad \textbf{Liquidity Risk}

The Bank holds sufficient liquid assets to enable it to continue normal operations even in the unlikely event that it is unable to obtain fresh resources from the capital markets for an extended period of time. Each year the Bank computes a prudential minimum level of liquidity based on projected net loan disbursements plus contingent liabilities and debt service payments averaged over two years. In addition, the prudential minimum level of liquidity includes all potential debt service payments due to early redemption of swaps and borrowings with embedded options. To enable the Bank to take advantage of lower-cost funding opportunities as they arise, the Bank’s policy permits an increase of liquid resources up to an operating level equal to the total of the prudential minimum, including undisbursed and irrevocable commitments.

To strike an optimal balance between generating adequate returns from investing liquid assets and holding securities that can be easily liquidated when the need arises, the Bank divides its investment portfolio into tranches with different liquidity objectives and benchmarks. To cover its expected operational cash flow needs, the Bank maintains an operational tranche of liquidity that is always invested in the most highly liquid securities. Probable redemptions of swaps and borrowings with embedded options are included in the computation of the size of the operational tranche of liquidity.

5 \quad \textbf{Currency Risk}

The agreement establishing the Bank explicitly prohibits it from taking direct currency exchange exposures by requiring liabilities in any one currency (after swap activities) to be matched with assets in the same currency. This is achieved primarily by holding or lending the proceeds of its borrowings in the same currencies in which they were borrowed (after swap activities). To avoid creating new currency mismatches, the Bank requires its
borrowers to service their loans in the currencies disbursed. However, to facilitate loan repayment for its borrowers that may not have easy access to certain currencies, the Bank provides currency purchase services on an agency basis.

Because a large part of its balance sheet is funded by equity resources denominated in Units of Account, the Bank has a net asset position that is potentially exposed to translation risk due to currency exchange fluctuations. The Bank’s policy is to minimize the potential fluctuation of the value of its net worth measured in Units of Account (equivalent to the SDR) by matching the currency composition of its net assets with the currency basket of the SDR.

The distribution of the currencies of the Bank’s recurring administrative costs shows a high concentration of expenses in Euros and CFA. The Bank seeks to mitigate the unfavorable impact of a potential rise in the value of the Euro by purchasing call options on the Euro to cover the estimated amount of Euro and Euro-related expenses for the fiscal year.

6  Interest Rate Risk

There are two principal sources of interest rate risk for the Bank. The first is the interest rate sensitivity associated with the net spread between the rate the Bank earns on its assets and the borrowings, which fund those assets.

In 1990, the Bank began offering "variable rate loans" whose interest rate resets semi-annually based on the average cost of a dedicated pool of the Bank’s borrowings. These pools are funded with a mix of fixed rate and floating rate borrowings to provide borrowers with broadly stable interest rates that gradually track changes in market interest rates. The cost of funds pass-through formulation incorporated in the lending rates charged on the Bank’s pool-based loans has traditionally helped to minimize the interest rate sensitivity of the net spread on this part of its loan portfolio.

The Banks also offers fixed and floating rate loans whose interest rate is directly linked to market interest rates. For the market-based loan products, the Bank’s net margin is preserved by using swaps to align the interest rate sensitivity of the loans with that of the Bank’s underlying funding (six-month Libor floating rate). The Bank also provides borrowers with risk management products such as swaps to modify the currency and interest rate terms of its market-based loan products. Although it prefers to retain the credit risks, the Bank safeguards the intermediation fee it earns on risk management products by simultaneously laying off the market risks with an approved derivative counterparty.

For the portfolio of liquid assets, the Bank protects its net interest spread by managing its investments within duration mismatch limits around benchmarks that replicate the interest rate characteristics of the underlying funding for each portfolio tranche. The portfolio of liquid assets is currently divided into three tranches to reflect the different business purposes and underlying funding. The core part of the investment portfolio is held to comply with the Bank's liquidity policy and uses a six-month Libor floating rate benchmark. The operational portfolio is managed to meet projected operational cash flow needs and uses a one-month Libor floating rate benchmark. In some currencies, liquidity is partially funded by the Bank's equity. For these portfolios the Bank uses a recognized 1-3 year fixed income bond index as its performance benchmark.
The Bank seeks to diversify the sources of its funding by issuing debt in a variety of markets and instruments. Unless fixed rate funding is required for one of its pool-based loan products, the Bank’s manages its net interest margin by simultaneously swapping all new borrowings into floating rate in one of the Bank’s active currencies on a standard six-month Libor rate reference. Where the Bank issues debt with embedded options, the Bank simultaneously enters into a swap with matching terms to synthetically create the desired six-month Libor-based floating rate funding. For interest rate management purposes, callable funding is considered as one alternative to issuing short-term debt such as Euro Commercial Paper.

The second principal source of interest rate risk is the interest rate sensitivity of the income earned from funding a portion of the Bank’s assets with equity. Changes in market interest rates in the Bank’s active currencies will largely determine the net income earned on loans funded by equity. In general, lower nominal interest rates result in lower lending rates, which in turn reduce the nominal earnings on the Bank’s equity.

In addition to these two principal sources of interest rate risk, the Bank is exposed to prepayment risk on the parts of its loan portfolio issued before 1996. Although the Bank is unable to charge a prepayment penalty on these older loans, in practice the level of prepayments has been relatively limited. In 2000, total loan prepayments, excluding operations related to the HIPC debt reduction initiative, amounted to less than 1% of the outstanding portfolio. For all market-based loans, the Bank protects itself from prepayment risk by linking the prepayment penalty to the cost of redeploying the funds at current market rates.

7 Operational Risk

The Bank, like all financial institutions, is exposed to many types of operational risks including the potential losses arising from internal activities or external events caused by breakdowns in information, communication, physical safeguards, business continuity, supervision, transaction processing, settlement systems and procedures, and the execution of legal, fiduciary, and agency responsibilities. The Bank maintains a comprehensive system of internal controls designed to keep operational risk at appropriate levels in view of the Bank’s financial strength and the characteristics of the activities and markets in which it operates. These internal controls are periodically updated to conform to industry best practice.

8 Risk Management Process

The processes and procedures by which the Bank manages its risk profile continually evolve as its activities change in response to market, credit, product, and other developments. The highest level of risk management is assured by the Bank’s Board of Executive Directors, which is chaired by the President. In addition to approving all risk management policies, the Executive Directors periodically review trends in the Bank’s risk profiles and performance to ensure compliance with those policies.
The senior-most management forum for risk management is the asset and liability management committee (ALCO). The Vice President for Finance and Planning chairs ALCO, which meet at least monthly to perform its oversight role. ALCO is supported by the Risk Management Unit, as advisor, and six standing working groups (the Country Risk, Private Sector Provisioning, Financial Products, Currency Management, Funding Management and Financial Projections working groups), that report to the ALCO on specific financial and risk management issues. The day-to-day operational responsibilities for implementing the Bank's risk management policies and guidelines are delegated to the relevant business units.