



AFRICAN DEVELOPMENT BANK

**PROPOSAL FOR A DEFINITION OF THE BANK'S RISK APPETITE,
RISK DASHBOARD AND ENHANCEMENT OF CREDIT RISK
GOVERNANCE**

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EXECUTIVE SUMMARY

Effective management of risk is critical to any financial institution's survival, especially in today's volatile financial markets and uncertain macroeconomic outlook. For development finance institutions in general and Multilateral Development Banks (MDBs) in particular, achieving this objective is made more challenging by the complex operating environment, the public-service mission and the cooperative nature of these institutions. Profit/financial return to compensate for risks taken is not the primary goal of MDBs. Against this background and given the limited capital resources available to support operations, a strong, agreed-upon and well communicated risk management framework is critical to the efficient execution of the institution's business strategy. Such framework must be adapted to the changing operating environment and aligned to best practices.

The Bank's risk management framework has evolved significantly over the years. Initially, the Bank's operational activities focused primarily on sovereign lending with limited low volume non-sovereign (private sector) transactions. Treasury activities were equally limited in volume and complexity.

With the growth in the Bank's business and in particular non-sovereign operations as well as the increase in the complexity of treasury related activities, Risk Management of the Bank is faced with several challenges in ensuring that: (i) capital is sufficient to support risk taking activities to maximize the development related objectives of the Bank; (ii) individuals who take or manage risks within the Bank clearly understand them and are held accountable for the risks assumed; (iii) the Bank's risk exposures are within the limits established by the Board of Directors and /or management, as appropriate; (iv) risk decisions are aligned to the Bank's business strategy and objectives set by the Board; and (v) adequate or reasonable compensation is received for the risks taken.

The increased calls from shareholders to the Bank to enhance its relevance and ensure effectiveness in all member countries have necessitated a comprehensive revision and strengthening of the Bank's overall risk management framework. During the discussions for the Sixth General Capital Increase (GCI-VI) of the Bank, shareholders requested an independent assessment of the Bank's risk management capacity in light of the expected substantial increase in lending to the private sector. The assessment was undertaken in 2009/2010 by the consulting firm Oliver Wyman.

While the assessment of Oliver Wyman concluded that the Bank has sound risk management foundations and was not in immediate danger from a risk perspective, they also proposed a number of recommendations aimed at further strengthening risk management in order to be in a position to address the inevitable challenges that lie ahead. They indicated that the Bank will gain in efficiency by integrating risk management activities in an Enterprise-wide Risk Management (ERM) framework.

The central recommendation made by Oliver Wyman was that the Bank should first clearly define its risk appetite, a cornerstone of an ERM framework. Indeed, a well

articulated risk appetite provides clear direction for the Bank's risk taking activities, thereby enabling the critical link between the Bank's strategy and day-to-day risk management. The definition of risk appetite is, however, a complex process requiring a careful balancing of different and sometimes even divergent views, perspectives and interests of various stakeholders regarding risks assumed, the use of risk bearing capacity and risk tolerance.

To enhance the objectivity of the definition of risk appetite and ensure the inputs of all shareholders, McKinsey & Co was appointed in September 2010 to assist the Bank in developing a risk appetite statement. In addition, McKinsey & Co were requested to develop a framework for a dynamic risk dashboard and to propose a framework for enhancing credit risk governance.

In February 2011, Management presented to the Board its comments on the recommendations made by McKinsey & Co. For the most part, Management concurred with the recommendations. Following the discussions with McKinsey & Co and the consultations with the Board, Management undertook peer review, benchmarking and consultation with risk advisory services to address issues that emerged during the discussions of the consultant's report. As a result of the above, Management makes the recommendations summarized below for the consideration of the Board of Directors.

1. Risk Appetite

(a) At portfolio level - increase the allocation of risk capital to private sector operations from the current limit of 40% to 50%.

(i) The increase should be gradual, incremental and subject to review during the annual presentation of the Medium Term Financial Outlook

(ii) The increase should comply with the following triggers:

- At 40% and above only projects with certain risk/ADOA parameters (risk rating ≤ 4 and ADOA ≤ 2) could be approved,
- At 50% of risk capital, no additional projects can be approved

(b) At single project level - maintain a maximum risk rating cut-off of 5 (the current limit) while

(i) Retaining the flexibility to finance high risk transactions, provided however that the total exposure to such high risk transactions, excluding equity investments, is limited to 10% of the risk capital allocation to private sector operations,

(ii) Trade-off between development outcome and financial risk by integrating an explicit achievability indicator into ADOA to monitor development outcome over time.

2. Strengthening Credit Risk Governance

Create a Credit Risk Committee to focus on end-to-end credit risk governance. The composition of the Credit Risk Committee shall be

determined by the President, based on the terms of reference of the committee.

3. Credit Risk Dashboard

Develop a Corporate Risk Dashboard Board in order to improve the risk reporting, using a phased or gradual approach.

I. INTRODUCTION

1.1 As a premier development financing institution on the continent, the Bank is frequently called upon to not only increase its lending volume, but also to take riskier exposures that are expected to yield higher development effectiveness and additionality. The assumption of more risks with a catalytic objective, particularly through increased interventions in the private sector in Africa in general, and in Lower Income Countries (LICs) in particular, is consistent with the Bank's mandate to mobilize and increase resources for financing development, especially in areas currently considered as being too risky.

1.2 Further, during the discussions of the Bank's Sixth General Capital Increase (GCI-VI), shareholders requested an assessment of the Bank's risk management capacity in the face of expected substantial increase in lending to the private sector. That assessment was undertaken in 2009/2010 by the consulting firm Oliver Wyman¹.

1.3 While the assessment of Oliver Wyman concluded that the AfDB has sound risk management foundations and was not in immediate danger from a risk management perspective, they also proposed a number of recommendations aimed at further strengthening risk management, to be better positioned to address the inevitable challenges that lie ahead. The key findings of Oliver Wyman in terms of materiality and institutional gap included, amongst others the fact that: (i) the Bank's risk appetite is not commonly understood throughout the organization; (ii) the Board does not receive a concise comprehensive risks report; (iii) there is a lack of an integrated risk management function across the organization and the positioning of such a function; and (iv) OPsCOM's mandate is too broad (i.e. it covers operational related strategies and policy matters, alongside individual loan proposals' review) and hence it is unlikely to play and also sustain the role of an effective credit committee.

1.4 In this regard, Oliver Wyman recommended² that the Bank: (i) set a common platform to address risk appetite and also translate the high level definition of risk appetite into clear operational targets and limits; (ii) design and implement concise risk reporting dashboards to enable the Board and Senior Management to have an effective monitoring tool of the key risks against the risk appetite metrics, (iii) adapt and strengthen the credit review and approval process to the expected increase in deal volumes, (iv) introduce changes in the risk management's reporting structure and integrate operational risk into the main risk management function in accordance with best practice ERM principles; and (v) keep monitoring the performance of ADOA.

1.5 In September 2010, McKinsey & Co were appointed to assist Management in developing specific proposals to:

- 1) Define and elaborate the Bank's risk appetite, based on discussions with Board members and Senior Management.

¹ ADB/BD/IF/2010/32/Add.1

² Management responses were provided on their recommendations (ADB/DB/IF/2010/32/Add.2)

- 2) Develop a framework for the implementation of a dynamic dashboard reporting system to facilitate the monitoring of the Bank's key risk metrics. This will involve the establishment of key performance and risk indicators (KPIs and KRIs) for the Bank.
- 3) Assist the Bank in enhancing the framework for credit risk governance.

1.6 The key finding and recommendations of McKinsey & Co have undergone several discussions and exchanges with Board members. Management has complemented them with additional peer review and benchmarking.

1.7 This document, consisting of 6 sections, summarizes Management's proposals, which are informed by the McKinsey study³ and reflect the consultations with stakeholders and in particular the Board. Following this introduction, section II presents the specific context of the Bank's risk appetite. Section III summarizes the key proposals of McKinsey, followed in Section IV by Management's proposals. Section V reviews the impact of the proposals on the Bank's financial capacity and key processes while section VI presents the conclusions. The document is supported by 5 annexes: Annex 1 provides the proposed comprehensive and formal risk appetite statement while Annex 2 provides a comparison of the credit processes of other MDBs while the suggested terms of reference for the proposed credit risk committee is in Annex 3. The timeline for implementing the proposals is in Annex 4. Annex 5 gives an example of the risk appetite template of a peer MDB.

II. SPECIFIC CONTEXT OF THE BANK RISK APPETITE

CONTEXT OF THE BANK'S RISK APPETITE DEFINITION

2.1 The compelling factors driving the need for a risk appetite statement are summarized in the sections below. It is important to note that currently the Bank's risk appetite is not clearly articulated as a formal "risk appetite statement", but is structured around: (i) strategic prudential limits on the Bank's operations (Risk Capital Utilization, leverage ratio, limit on equity participation); and (ii) operational limits on risk capital allocations (Private Sector versus Public sector) and cut-off ratings.

Prudent Management of GCI-VI Resources

2.2 Two major expectations of the Bank's stakeholders relating to GCI-VI drive the need for clarity of the institutional risk appetite: (i) the need to maintain strong financial capacity to avoid any call on callable capital and to defer another capital increase as far into the future as possible; and (ii) the need to address the specific needs of Low Income Countries (LICs) and Fragile States (FS) through increased private sector activities.

2.3 **External Stakeholders' concerns** - Since the financial crisis, there has been a renewed focus of external stakeholders (i.e. essentially rating agencies in the case of DFIs) on the strength of institutional risk management frameworks. Rating agencies, during their annual rating reviews of the Bank, have expressed concerns about the speed of growth of the private sector operations and associated

³ ADB/BD/WP/2010/201

consumption of the Bank's risk capital. They are increasingly seeking clear boundaries and guideposts that inform the nature and amount of risks a financial institution undertakes. Furthermore, external auditors have commented on the increase in the number of projects approved which are rated above the cut-off of 5, as well as on certain weaknesses in the institutional governance of the credit process. These concerns were also expressed by the internal auditors.

2.4 The above developments therefore call for: (i) a comprehensive assessment of the Bank's capacity to support non-sovereign risk; (ii) a better alignment of the allocation of risk capital with the business strategy and communication of prudential exposure limits across the institution; and (ii) the need to strengthen the credit risk governance process.

Risk Management Reforms

2.5 Emerging best practices in risk management call for an Enterprise-wide Risk Management (ERM) framework built on a solid foundation of a well articulated Risk Appetite. Recent recommendations of international regulatory bodies (Basel) highlight the fact that financial institutions should not only define risk appetite and communicate it to stakeholders, but should also disseminate the information throughout the institution, in the form of effective operational limits, controls and mitigation measures.

RISK APPETITE DEFINITION

2.6 Risk appetite is commonly defined as: (i) the level of risks an organization is willing to assume taking into account its overall risk bearing capacity, (ii) the extent of these exposures is defined through various quantitative financial metrics and non-financial parameters, and (iii) the governance and reporting of these risks. It draws the line between those risks which are acceptable and those considered unacceptable.

2.7 A well articulated risk appetite should be reflective of the organization's operating environment, strategy, business plans and shareholder expectations. It should be set for a specific timeframe and reviewed periodically to take into account changes in the external environment as well as changes in the entity's business. Risk appetite should be defined in the form of a risk appetite statement, including multiple quantitative and qualitative measures, and communicated to stakeholders inside and outside the Bank.

Risk appetite Components

2.8 Generally, risk appetite forms the boundaries of a dynamic process that encompasses strategy, target setting and risk management, alongside risk bearing capacity. It also forms the basis for establishing limits, controls and mitigation measures as illustrated by Figure 01 below. Therefore risk appetite and business strategy must be aligned to risk bearing capacity and its established limits.

2.9 **Risk Capacity** - Risk appetite is always linked to the overall risk bearing capacity which is the maximum amount of risk that the Bank can bear and is normally determined as a function of available capital, liquid assets and borrowing capacity. In this respect, the Bank uses two measures of risk bearing capacity.

- **Risk Capital (narrow based capital)** consisting of paid-in capital and reserves (including loan loss reserves) which is meant to support the balance sheet risk exposure (essentially DRE and Treasury Assets); and
- **Usable Capital (broad based capital)** consisting of risk capital and callable capital of shareholders rated A- or better which is meant to provide capital support for borrowings (balance sheet liabilities).

2.10 The Bank’s risk capital is expected to be around UA 10.6 billion by the end of the encashment period of GCI-VI (including annual transfers of income to reserves). The risk capacity headroom is measured by a metric called Risk Capital Utilization Rate (RCUR) which threshold is set at 100% of total available risk capital.

2.11 **Risk tolerance** - it refers to the degree of risk acceptable to the Bank in order to achieve its business strategy and objectives while operating within the broad risk appetite. The Bank risk tolerance has so far been defined by limiting the total exposure on all operations at 100% of risk capital and by limiting the amount of risk capital allocated to private sector operations. It has increased considerably since 2000 and it is currently set at 40% of the total risk capital.

2.12 **Risk Limits** - Risk appetite is structured around the main type of risks and cascaded down to the various business units in the form of limits (e.g. maximum concentration limit equivalent to 15% of the total risk capital, sector limits at 25%-35% of risk capital, single private sector obligor limit of 6% of risk capital, etc.). These limits, their controls and related risk mitigation measures should be effective in steering the risk profile so that they remain within the targets set by the risk appetite.

Figure 01 : Key elements of the Risk Appetite Definition



Risk appetite as a Cornerstone of Risk Management Framework

2.13 Risk appetite documented in the form of “Risk Appetite Statement” provides a cornerstone for the risk management framework. As illustrated by Table 01, the challenge for its implementation lies in the extent of the effectiveness or robustness of the risk governance and reporting systems that ensure that day-to-day business decisions (e.g. loan approvals) are made in line with the risk appetite statement.

Table 01: Linkage between Risk Appetite and Risk Management Framework

Risk Management	Linkage to Risk Appetite
Risk Assessment (evaluation, quantification, aggregation and stress testing of risk profile)	Identification of new and changing profile in the context of risk appetite. Prioritization and refocusing risk management and control activities.
Risk Governance	Risk appetite embodied in risk policies, guidelines, process and procedures and implemented by risk committees.
Risk Monitoring and control	Monitoring and reporting compliance and performance against limits and targets based on risk appetite.
Risk control and mitigation	Control calibrated in line with risk appetite Risks minimized and value addition to shareholders.

EVOLUTION OF THE BANK'S RISK APPETITE AND TOLERANCE

2.14 The Bank has been a predominantly sovereign lender since its establishment. However, since 2000, the Bank has consistently increased the risk capital allocation to private sector during each capital adequacy review as illustrated in Figure 02 below. The primary objective was to increase lending headroom for private sector operations through adequate capital back-up.

In this gradual process, the capital adequacy policy and credit policy acted together to shape the risk appetite of the Bank.

Figure 02: Dynamic of the Bank's Risk Appetite

Indicators		1996-2000	2001-2008	2009-2010	2011-2020
Share of Risk Capital	Public	80%	80%	60%	50%
	Private	20%	20%	40%	50%
Cut -off Rating	Public				
	Private	4	4-5	4	5
RCUR	Public	75%	47%	30%	
	Private	2%	5%	23%	
Outstanding Portfolio	Public	99.5%	94.5%	80.3%	
	Private	0.5%	5.6%	19.7%	

The 80%-20% Public / Private Risk Capital Allocation

2.15 Since its credit rating downgrade by Standard & Poor's in 1995, the Bank's risk management of lending operations has evolved significantly, always with the cardinal principle of preserving its AAA rating. Increased attention was given to maintaining a sound portfolio quality to prevent a high level of impairments in both public and private sector portfolios. The Bank also adopted the credit policy in 1995 to monitor exposure to high risk transactions and limit public sector lending to only the most creditworthy countries. In 2000, the Bank also approved a capital adequacy and exposure management framework aimed at monitoring its risk capital utilization. Within that framework, 20% of its total risk capital was earmarked for private sector operations to respond to one of the GCI-V objectives, which was an increase of private sector activities.

The 60%-40% Public /Private Portfolio Limit

2.16 The success of GCI-V and the implementation of certain agreed-upon institutional and operational reforms collectively facilitated the regaining of the Bank's uniform AAA rating in 2003. Since then, there have been several internal and external developments that have changed the Bank's portfolio risk profile and its "risk appetite".

2.17 **Declining sovereign portfolio and high concentration risk-** The strengthening of the Bank's financial position was accompanied by (i) a steady decline in its development-related exposures (loans and equity participations), primarily due to significant prepayments attributable largely to more favorable market conditions for some of the Bank's clients, as well as (ii) improved portfolio quality as a result of several arrears clearance initiatives. The alignment of the Bank's credit policy to that of the World Bank, led mechanically to a high level of portfolio concentration with the 5 largest borrowers representing between 60 and 70% of the Bank's outstanding portfolio while annual approvals to the Northern and Southern regions averaged 55% from 2000 to 2008.

2.18 **Low risk capital utilization level -** The combination of the above factors resulted in a steady decline in the Risk Capital Utilization Rate (RCUR). The relatively low level of RCUR triggered a debate amongst key stakeholders of the Bank regarding the optimum use of its risk capital to fulfill its development mandate. Consequently, the Bank has had to intensify its efforts to improve its risk profile within a country (sovereign vs. non sovereign risk) while reducing overall country exposure through a larger client base.

In response to the developments and circumstances described above, the Bank reviewed its capital adequacy framework in 2009 and doubled the risk capital allocation for private sector operations to 40%. Such limit is to be reviewed periodically, taking into account the future evolution of its business risk profile.

III. SUMMARY OF MCKINSEY REVIEW AND RISK APPETITE PROPOSAL

3.1 Between September and November 2010 the Board participated in a series of bilateral (one-on-one discussions) and informal meetings during the development of McKinsey’s proposals for the definition of the Bank’s Risk Appetite Statement, Risk Dashboard and Enhancing Credit Risk Governance.

3.2 The proposals that are summarized in Table 02 were informed by these consultations, independent assessments and benchmarking.

Table 02: Summary of McKinsey’s Proposals

Issues	Summary of McKinsey’s Recommendations on the Risk Appetite, Risk Dashboard and Credit Risk Governance
<p>Risk Appetite</p>	<p>The focus is on a new structure of exposure limits and risk rating at both portfolio and individual project level aimed at ensuring that the Bank fulfills its mission in reaching LICs (where Private Sector plays a crucial role).</p> <p>(a) At portfolio level -balance between public and private sector</p> <ul style="list-style-type: none"> • Increase the risk capital (i.e., Bank’s reserves and paid-in capital) allocation to private sector from the current limit of 40% to 50% with triggers: <ul style="list-style-type: none"> ○ From 40% and onward only projects within certain risk/ADOA parameters (e.g. risk rating ≤ 4 and ADOA ≤ 2) could be approved; and ○ At 50% of risk capital, no additional projects shall be approved. ○ Average risk rating target of the private sector portfolio is maintained between 3 and 4. <p>(b) At single project level</p> <ul style="list-style-type: none"> • Maximum risk rating cut-off of 5, which is the current limit; and • Maintain flexibility to enter by exception into high risk transactions; provided that total exposure to high risk projects is limited to 10% of risk capital, excluding equity participation. <p>The proposal also strives to strengthen the Bank’s ability to assess trade-off between development outcome and financial risk by integrating an explicit achievability indicator (similar to EBRD) into ADOA to monitor development outcome over time.</p>
<p>Risk Dashboard</p>	<p>a) Although the current risk reporting systems provide information on most relevant risks, improvements could be made through the development of a Corporate Risk Dashboard.</p> <p>b) Because of the high demand of the Dash board in terms of information collection, a gradual approach is proposed.</p>
<p>Credit Risk Governance</p>	<p>The proposal focuses on strengthening the current credit risk management process and independence to complement OPsCom’s activities. It recommends that:</p> <p>a) The Bank establishes a Credit Risk Committee (CRC) to focus on end-to-end credit risk governance, Credit assessment, Portfolio monitoring and rating change approval. The CRC will compose of management/senior staff and risk</p>

Issues	Summary of McKinsey's Recommendations on the Risk Appetite, Risk Dashboard and Credit Risk Governance
	<p>experts not involved in deal structuring.</p> <p>b) OPsCom's Terms of Reference should be updated to allow effective interaction with the Credit Risk Committee:</p> <ul style="list-style-type: none"> • OPsCom will make the final decision on projects including clearance for Board's distribution; and • OPsCom can overrule the recommendation made by the Credit Risk Committee and shall provide a documentation detailing the rationale for the decision to overrule in this respect; <p>c) Creation of a dedicated workout unit as the portfolio grows and matures.</p>

IV. MANAGEMENT PROPOSALS

4.1 Management concurs with the general thrust of McKinsey's recommendations presented above. However, based on the further review, benchmarking, consultation with risk advisory services, the following proposals are made.

RISK APPEPITE

4.2 **The proposed comprehensive risk appetite statement is presented in Annex 1** and is summarized in terms of risk capital allocation to the various types of lending and risk categories in Table 03 below. It takes into account the key elements of the Bank's strategic directions and GCI-VI undertakings, which highlight that operations should reach out to LICs and fragile states and that the private sector should play a crucial role in supporting this category of countries as sovereign lending remains limited by the credit policy to only 16 eligible countries. This implies an increased share of private sector operations in the Bank's portfolio to leverage the capital provided by the GCI while maintaining a sound portfolio quality.

4.3 However, it should be noted that the public sector is likely to continue to dominate the portfolio for a number of years if past lending and disbursement growth profiles of MICs⁴ are maintained. In order to maintain the growth momentum and the quality of the portfolio, MICs need to be kept actively engaged with the Bank. It should also be noted that with the improvement of business governance in several regional member countries, there is an expectation of some of them graduating from ADF-only-eligible to ADB eligible borrowing members.

It should also be highlighted that the risk capital of the Bank is meant to provide adequate capital back-up for all the risks which the Bank incurs. In this regard, non-core risk activities (treasury and operational risk) also require capital backing. For this purpose, and based on the Bank's historical experience, 10% of total risk capital is allocated to non-core risk activities with the remaining 90% being

⁴ MICs have generally higher absorptive capacity, account for a large portion of the lending program

allocated to development related risks. The allocation of 90% to core lending will be further attributed with the long term 50%-50% rule to sovereign and non-sovereign operations (i.e. 45⁵% sovereign; 45% non sovereign). High risk transactions will represent 10% of the allocation to non-sovereign operations

Table 03: Bank’s Portfolio Risk Allocation over a long term planning horizon-2020

Risk Type	% Total RC	Type of Lending	% Allocable RC	% Total RC	Allocation by instrument	% Total RC
Core Risks (Risk Capital Available for Lending Activities)	90%	Private Sector	50%	45%	Equity	15%
					Loans	30%
					Private Sector RC	45%
		Public Sector	50%	45%	Public Sector RC	45%
Non-Core Risks	10%			10%		10%
Total Risk Capital	100%			100%		100%

(RC= Risk Capital)

Gradual Implementation with periodic Review

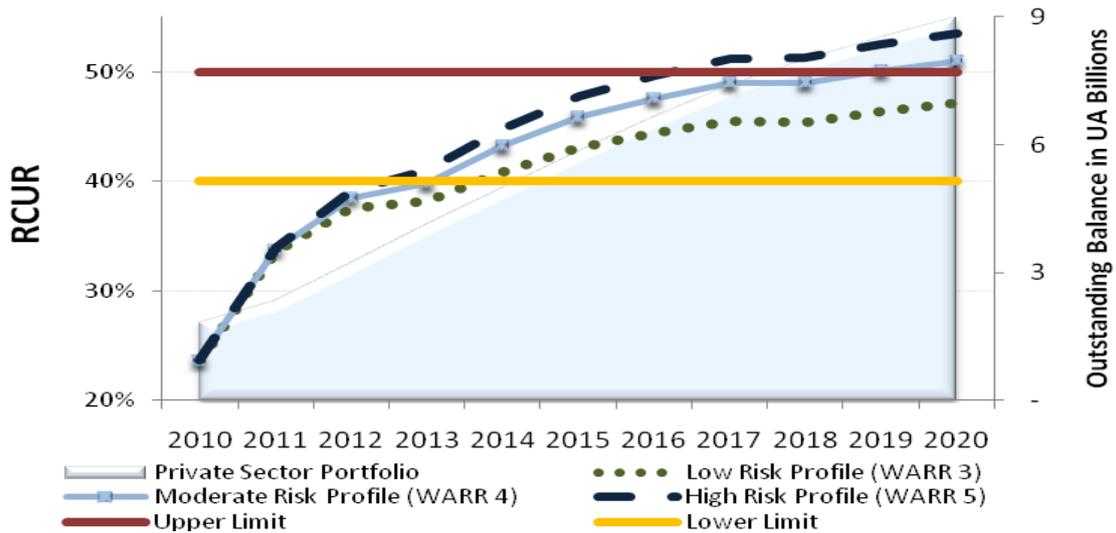
4.4 Management proposes that the increase of the limit of 40% for non-sovereign guaranteed operations to 50% should be gradual. There are several prominent factors that call for a gradual and prudent increase:

- The additional risk capital is meant to sustain the private sector portfolio growth and any increase should mirror this growth profile. It should be based on the actual evolution of the portfolio risk profile which is still quite young with many projects yet to reach the repayment period.
- Implication for the strategic prudential ratios of the Bank and in particular RCUR- the growth in the use of private sector additional risk capital should not result in an earlier breach of RCUR, i.e.; affecting the Bank’s long-term financial sustainability.

4.5 The process of achieving this gradual implementation is to assess the trade-off to be made between the levels of increase in risk bearing capacity (as augmented by GCI-VI encashment) and the level of increase in the private sector outstanding commitment and risk profile (as lending increases and the currently young portfolio matures). Because of the impact of non-sovereign portfolio risk profile (WARR) on the utilization of the risk bearing capacity three scenarios have been developed: (i) a low case (WARR=3); (ii) moderate (WARR between 3-4); and (iii) high case (WARR of around 5). Their impact on the non-sovereign portfolio risk capital utilization is illustrated by Figure 03.

⁵ The 45% is equivalent to 50% * 90% core risk capital

Figure 03: Evolution of Non-Sovereign RCUR and Portfolio Risk



4.6 **Based on the expected evolution of the portfolio risk profile it is suggested to follow a two step process increase: (45%) over the 2012-2015 planning horizon; and (ii) 50% by end 2020.**

4.7 This proposal is made on the premise of : (i) **increased leverage**⁶ (increasing the level of funding per project/per UA risk capital allocated by the Bank) of capital resources to be allocated to LICs and FS; and (ii) **periodic off-loading of risks**. By increasing the leverage, the Bank would send a strong message to stakeholders (in particular rating agencies and the market) that it stands behind LICs while maintaining a strong financial position.

4.8 **The risk appetite statement should be reviewed periodically**, typically every 3 years or when substantial changes in the industry or market environment warrants, ensuring that it remains in line with the expectations of the Bank’s shareholders. This review would enable the Bank to make well-informed decisions on potential risk capital re-allocations.

Risk capital allocation targets

4.9 **At portfolio level**, the need for a trigger together with a binding limit system for private sector operations is required in order to manage the balance between non-sovereign versus sovereign exposures. This would enable the Bank to still entertain opportunities which may arise once the trigger level has been reached, but at an increased level of caution (such as lower risk, high development effectiveness projects). It also goes with an independent assessment of private sector operations contracted since inception.

4.10 **At single deal level** - In line with the Auditors’ recommendations to fully disclose projects rated above the cut-off in terms of potential losses, Management

⁶ Credit substitutes could be used in cases of lower risk capital allocation than straight loans.

proposes that such exception reporting shall remain an integral part of the Summary Credit Risk Note currently provided to the Board.

As indicated above, the increase in risk appetite would permit the Bank to consider risky projects with strong development impact (portfolio level limit) while also protecting the Bank from over-exposure to high risk transactions (single deal level limit).

4.12 Management believes that the proposed risk appetite statement does not constitute an obstacle for the expansion of private sector operations.

It should be recalled that without GCI-VI or with a lower level of paid-in capital, the Bank would have had to stop its private sector operations by 2012 or restrict it to a negligible size. Instead, with the new level of capitalization, the Bank will be in a position to lend between UA 1 and 1.5 billion per year for private sector projects over a foreseeable future with a larger proportion in LICs, versus public sector operations of around UA 2.3 to 2.8 billion per year over the same period. This commitment capacity will further increase if the evolution of the portfolio risk profile over the projection period is satisfactory with limited losses. This can be achieved through sound structuring of high and very high risk projects to bring the expect losses at an equivalent of rating 5 or below.

4.13 For comparison purpose Annex 5 provides an indicate risk appetite profile of a peer MDB.

CREDIT RISK GOVERNANCE

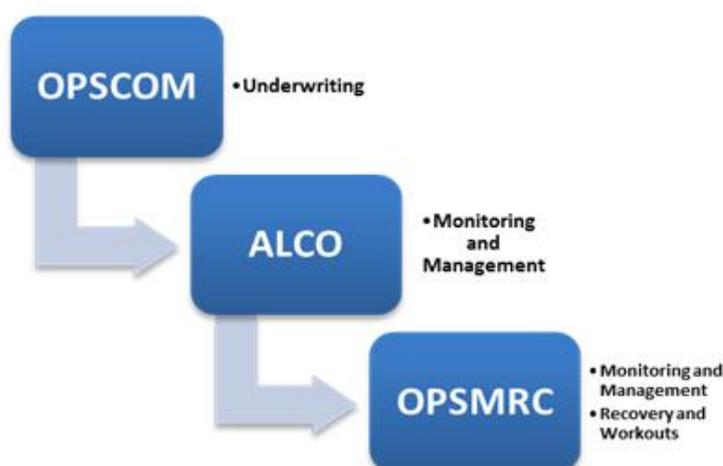
Rationale

4.14 As a development institution, the Bank is expected to take higher risks than a typical commercial institution. Indeed, to ensure relevance to all shareholders, the Bank has committed under GCI-VI to increase its private sector operations in LICs and fragile states. However, to ensure its sustainability and financial integrity, the Bank should continue operating on sound banking principles, key to which is strong credit risk governance.

4.15 Increase in the volume and complexity of exposures requires streamlined and strong processes- As noted by the Oliver Wyman assessment of the Bank's risk management capacity, the move towards much larger exposure to private sector entities in LICs and Fragile States means that the Bank can no longer operate in a "business as usual" mode.

4.16 Currently the risk governance of the various credit activities of the Bank is somewhat fragmented and scattered across several institutional organs and complexes without synergies as shown in Figure 04. For example, under the current process, OPsCOM reviews and approves public and private sector operations for consideration by the Board. ALCO on the other hand, reviews and approves country risk ratings and changes and oversees the monitoring of country risks and non-sovereign portfolio reviews. So, OPsCOM has no overall view of the evolution and quality of the portfolio over time after its approval of the new operations for the Board.

Figure 04 – Risk Governance



4.17 **In order to strengthen credit risk and to ensure end-to-end risk governance, Management proposes to establish a dedicated credit risk committee (CRC) as a complement to OPsCOM where all credit risk related issues will be discussed and a formal credit recommendation will be made for OPsCOM consideration. Annex 2 provides a comparison of the credit processes at other MDBs.**

Benchmarking

4.18 Given the nature, scope of activities and business portfolio⁷ profile, the best comparators to the Bank as a regional development Bank, are IADB and AsDB. From a risk perspective, Africa is the riskiest continent, with LICs and Fragile States accounting for 38 of the Bank’s 53 regional member countries. It is also important to consider that: (i) the Bank’s private sector portfolio represents roughly 21% of its total development exposure versus 6.7% and 5.1% respectively for ASDB and IADB⁸, and (ii) the expected increase in private sector exposure in response to GCI-VI undertaking. In consequence, the Bank’s private sector underwriting risk governance cannot be managed as “business as usual” and it appears imperative to enhance the credit risk process and strengthening the oversight of the risk profile evolution of the portfolio. Hence the proposal to establish a credit risk committee which effectiveness will be reviewed one year after its establishment.

Relationships and Synergies between OPsCOM and the CRC

4.19 **The CRC will be the body in charge of end-to-end credit risk governance** and will have functions which include: (i) the approval of ratings and recommendation of investment and loan proposals for submission to OPsCOM; (ii) periodic review of the portfolio of existing transactions and investments including the approval of rating change and waiver approvals; (iii) the approval of country ratings and exposures limits; (iv) approval and review of credit policy, guidelines

⁷ Both sovereign and non-sovereign portfolios in the same balance sheet.

⁸ Fitch Ratings Special report, 9 March 2011: Multilateral Development Banks receive fresh capital due to fast growth in Lending. Data as at December 2009.

and credit exposure management policies. The proposed Terms of Reference for the CRC are shown in Annex 3.

4.20 **Under the proposed structure, OPsCOM will remain as the final, pre-Board, decision-making body**, with the authority to overrule the credit recommendations from the CRC. In other words, OPsCOM may ultimately clear for Board consideration a proposed transaction with strong development impact that has in effect been rejected from a purely credit risk perspective by the CRC. In this regard, it is critical that OPsCOM develops clear guidelines, procedures and parameters for the over-ruling recommendations from the CRC in order to make the process as transparent, fair and consistent as possible.

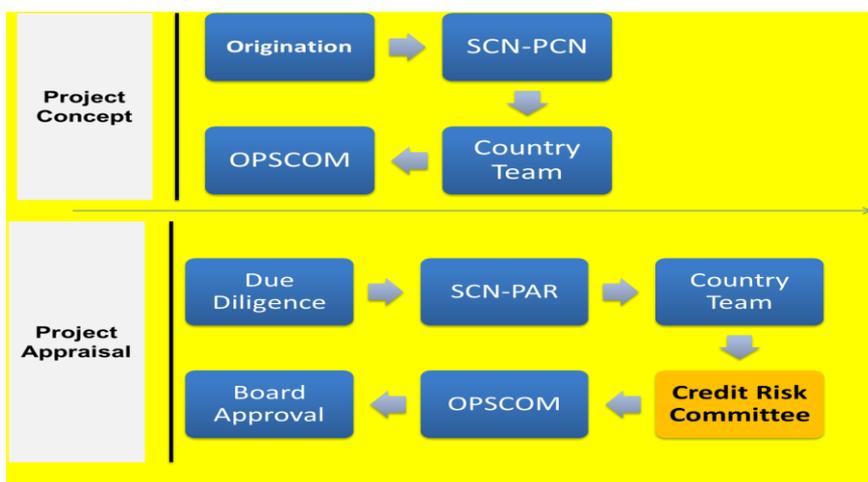
4.21 Furthermore, in order to ensure transparency, both the negative credit risk recommendation from CRC (in effect the current Summary Credit Note including a formal recommendation) and OPsCOM’s justification for the override shall be documented and form part of the submission to the Board together with the other project documentation.

4.22 **A streamlined work flow and a service level of agreement (SLA)** will allow the CRC as a new relevant layer of decision making to perform its function without unnecessary bureaucracy that may cause delays in the underwriting process. In this regard, the SLA will be established for all the functions of the private sector underwriting which implicate the CRC.

4.23 Management considers the creation of the Credit Risk Committee as a key pillar to institutional governance of risk together with the establishment of an enterprise-wide risk management framework covering all aspects of risk (operational, credit, market, etc.) supported by a dedicated risk management function. *The proposed CRC and its end-to-end credit risk governance (new transactions, portfolio monitoring, rating changes, waivers...) are shown in Figure 05.*

Figure 05: Process for a new Transaction, at portfolio level and other credit Risk Decision

Transaction Processing



Portfolio and Other Credit Risk Related Decision

Credit Risk Committee

- Underwriting
- Monitoring and Management
- Recovery and Workouts
- Other Credit Risk Decisions

RISK DASHBOARD

4.24 The Risk Dashboard is one of the modules of the Management Information System (MIS) that provides concise and customized risk reports that cascade from high level Board to lower level Management in order to answer management's key questions.

4.25 Although a large number of risk reports are already available in the current risk reporting systems and provide information on most relevant risks, some improvement areas exist and can be enhanced by developing a Risk Dashboard.

4.26 The dashboard simplifies the reporting but has significant demand in terms of data, systems, definition of service level standards and assigned responsibilities for reporting processes. Management agrees with the risk dashboard proposals of McKinsey and further proposes that the implementation of the Risk Dashboard shall be gradual and phased.

4.27 The Given the technical specification required, the Dashboard template will be presented to the Board by Year-end 2011.

V. IMPACT ON FINANCIAL CAPACITY AND KEY PROCESSES

FINANCIAL IMPLICATIONS

5.1 As noted earlier the risk appetite statement by nature is dynamic and the proposed limits are subject to periodic review. The section below provides some indications on its implication for the Bank's risk bearing capacity.

5.2 As summarized in Table 05, the Bank's exposure for non-sovereign operations stood at 22% of the total outstanding portfolio (disbursed and undisbursed). In the current "risk appetite profile" of the Bank 40% of total risk capital is allocated to non-sovereign operations. The current exposure consumed 63.3% of that allocated risk capital (corresponding to 25.20% of the total risk capital of the Bank).

Table 05: Risk Capital Utilization and Exposure as of end December 2010

	Limit	RCUR	Notional Exposure		WARR
			Disbursed	Undisbursed	
Public Sector	60%	16.78%	6,694	4,338	2.01
Private Sector of which*	40%	25.20%	1,909	792	3.12
Equity	15%	8.35%	216	258	5.23
Single Country	25%	11.64%	733	58	
Single Sector**	25%/35%	20.91%	782	135	
Single Obligor	6%	5.38%	385	-	

*Including Ned bank subordinated loan of UA 73 million; ** Financial Sector

5.3 Future exposure presented in Table 06 indicate that by 2020 the non-sovereign portfolio is expected to reach 35% of the disbursed and outstanding portfolio and will consume around 51% of the total risk capital of the Bank when undisbursed commitments are factored in the forecast. However, the Bank's exposure is likely to remain predominantly dominated by its public sector exposure depending on the real demand. This is because: (i) private sector loans generally have a shorter life than public sector (10 to 12 years against 20 years for public loans) which translates into a quicker turnover of the non-sovereign portfolio; and (ii) there relationship between risk capital allocation and exposure is not one-to-one. One UA million in risk capital can generate between UA 1 to 7 million in exposure depending on the riskiness of the transaction

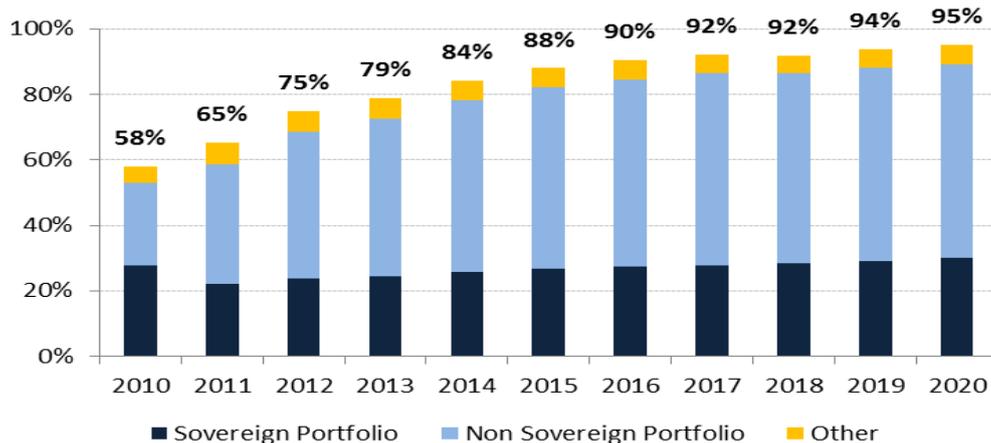
Table 06: Evolution of the Portfolio and consumption of risk capital (Amount in UA billion and %)

	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Lending Programme	3.6	3.6	3.6	3.6	3.8	4.0	4.2	4.4	4.6	4.9
Public Sector	2.5	2.3	2.3	2.2	2.3	2.5	2.6	2.7	2.8	3.0
Private Sector	1.1	1.3	1.3	1.4	1.5	1.6	1.6	1.7	1.8	1.9
Outstanding Portfolio	10.1	12.1	14.2	16.3	18.1	19.9	21.8	23.5	25.3	27.0
Sovereign	7.8	9.2	10.7	12.3	13.5	14.7	16.0	17.2	18.5	19.9
Non Sovereign	2.3	2.9	3.5	4.0	4.6	5.2	5.8	6.3	6.7	7.1
Share of Private Sector	23%	24%	25%	25%	25%	26%	27%	27%	27%	26%
Share of Public Sector	77%	76%	75%	75%	75%	74%	73%	73%	73%	74%
RCUR										
Sovereign	21%	24%	27%	29%	31%	32%	33%	34%	35%	37%
Non Sovereign	34%	39%	40%	43%	46%	48%	49%	49%	50%	51%

5.4 Under the risk appetite scenario further assuming equal distribution of the lending program between the two windows (sovereign, non-sovereign), the risk capital utilization rate of the non-sovereign portfolio will be around 59% of the total risk capital of the Bank as illustrated by figure 06.

Therefore increase the risk capital allocation to private sector operations over the long run towards 50% is an appropriate decision.

Figure 06: RCUR by Lending Window under Risk Appetite Scenario



OPERATIONAL IMPLICATIONS

5.5 The operational implications are essentially related to changes required in institutional processes and oversight organs in charge of credit risk management and governance.

5.6 The proposed Credit Risk Committee would take over the credit risk related responsibilities from ALCO, OPSMRC and OpsCom to ensure an end-to-end approach while the functional responsibilities of the divisions/departments would not change.

5.7 Therefore the TOR of ALCO, OpsCOM and OPRSM will have to be amended to reflect the new focus of their activities.

5.8 To help assure efficiency, the work of the CRC should be guided by the process workflow and the Service Level Agreement Framework (SLA) in Table 07 below.

Table 07: SLA based processing time of the decision making support

List of documents	Meeting Type			SLA Timeline*
	Regular Weekly Meetings	Quarterly	Ad-hoc	From submission to final decision
Summary Credit Note (PAR)	✓			3 days
NSCRWG Report		✓		5 days
COWG Report		✓		5 days
Country Risk Note			✓	2 days
Obligor / Transaction SCN (change in outlook or rating)			✓	2 days
Waivers requests / Change on conditions			✓	5 days
Guidelines, Policies, Procedures			✓	2 weeks

*Indicative timeline.

VI. CONCLUSION

6.1 Risk management is a key enabler to ensure that future portfolio growth will not jeopardize the Bank's overall financial integrity. Credit risk is the most important risk to which the Bank is exposed in the conduct of its core business of providing development financing to regional member countries. Given the relatively higher risk in non-sovereign lending, a robust institutional governance structure is imperative. The implementation of a credit committee is a key milestone in the process and needs to be complemented in the Medium term by an Enterprise Risk Management framework and decentralized risk management culture.

6.2 Overall, Management concurs with the broad thrust of the proposals submitted by McKinsey.

6.3 The project implementation timeline is provided in Annex 4.

Management proposes for the Board's consideration and endorsement the following:

1. Risk Appetite

(a) At portfolio level - increase the allocation of risk capital to private sector operations from the current limit of 40% to 50%.

(i) The increase should be gradual, incremental and subject to review during the annual presentation of the Medium Term Financial Outlook

(ii) The increase should comply with the following triggers:

- At 40% and above only projects with certain risk/ADOA parameters (risk rating ≤ 4 and ADOA ≤ 2) could be approved,
- At 50% of risk capital, no additional projects can be approved

(b) At single project level - maintain a maximum risk rating cut-off of 5 (the current limit) while

(i) Retaining the flexibility to finance high risk transactions, provided however that the total exposure to such high risk transactions, excluding equity participations, is limited to 10% of the risk capital allocation to private sector operations,

(ii) Trade-off between development outcome and financial risk by integrating an explicit achievability indicator into ADOA to monitor development outcome over time.

2. Strengthening Credit Risk Governance

Create a Credit Risk Committee to focus on end-to-end credit risk governance. The composition of the Credit Risk Committee shall be determined by the President, based on the terms of reference of the committee.

3. Credit Risk Dashboard

Develop a Corporate Risk Dashboard Board in order to improve the risk reporting, using a phased or gradual approach.

RISK APPETITE STATEMENT

Mission and strategic guidelines

The mission of the African Development Bank (AfDB) is to provide increased and effective development assistance to the regional member countries, through funding of sovereign and non-sovereign projects. Developing the private sector – especially in low income countries – is essential to achieve AfDB’s mission, and increasing operations in area is thus important to the Bank. To achieve its mission, AfDB wants to ensure that private sector operations account for ~40% of total new approval volumes by 2020. The weight of the private sector on AfDB’s total outstanding portfolio volume will thus reach ~30% by 2020. This strategy translates into:

- **New sovereign sector loan** approvals growing from UA 2.3 to 3.0 bn.
- **New private sector loan** approvals growing from UA 1.1 to 1.9 bn.
- **New approvals on equity** investments moving from UA 0.2 to 0.15 bn.

Overall risk appetite

The risks taken to pursue AfDB’s development mandate should **neither harm the AAA rating of the Bank nor put it in the position to call for callable capital** or ask for further general capital increases before 2020 from RMCs and NRMCS. This statement should hold across a range of stressed economic environments:

- Portfolio rating distribution 1-notch downgrade
- Default of the largest sovereign borrower, assuming 100% LGD
- Default of the 3 largest non sovereign borrowers, assuming 100% LGD AfDB also wants to maintain enough capital to stay in business even in the event of:
- Default of the 3 largest sovereign borrower, assuming 100% LGD In addition to the above mentioned single-factor stress tests, AfDB will develop multi-factor scenario analyses to test the portfolio against a list of predefined macroeconomic scenarios that are relevant to the Bank. To maintain the highest credit rating and a sufficient capital base, AfDB wants to maintain the **RCUR** (the ratio between the risk capital absorbed by the bank’s portfolio and the Bank’s risk capital) **below 100%** and **total debt should never exceed total usable capital** (leverage policy – total usable capital defined as paid-in capital + capital from subscribers with rating of A- or better)

AfDB’s risk profile should also be optimized using **risk transfer** and **risk mitigation** tools.

Risk tolerance

AfDB is **willing to seek and manage credit and equity risks from sovereign and non-sovereign operations** that the Bank has a natural advantage in owning,

to fulfill its mission of maximizing Additionality and Development outcome in the RMCs.

In order to protect the Bank's portfolio for the higher risk inherent in private sector operations, AfDB wants to maintain these operations within certain boundaries:

(c) **At portfolio level** -balance between public and private sector

- Increase the risk capital (i.e., Bank's reserves and paid-in capital) allocation to private sector from the current limit of 40% to 50% with triggers:
 - From 40% and onward only projects within certain risk/ADOA parameters (e.g. risk rating ≤ 4 and ADOA ≤ 2) could be approved; and
 - At 50% of risk capital, no additional projects shall be approved.
 - The **maximum binding limit on private sector operations cannot be breached** and the maximum private sector risk capital allocated to **equity investments should remain below 15%** of total risk capital and is **included in the total private sector risk capital** (bounded by the 40% trigger and 50% limit described above)

These limits will remain valid for a period of at least 3 years.

The **weighted average risk rating** on sovereign and non-sovereign portfolios should remain between 3 and 4, on AfDB's internal credit rating scale.

(d) **At single project level**

- Maximum risk rating cut-off of 5, which is the current limit; and
- Maintain flexibility to enter by exception into high risk transactions; provided that total exposure to high risk projects, excluding equity participations, is limited to 10% of private sector risk capital.
- This model allows the Bank to maintain a balanced risk position by compensating small high-risk deals with large low-risk deals.

AfDB seeks to compensate for credit risks with a pricing that covers P&L costs.

All other risks which are not strictly related to AfDB's mission or which AfDB has no competitive advantage in managing, **should be avoided, minimized or insured to protect AfDB capital:**

- **Market risks** (currency, interest rates) should be systematically hedged

- **Liquidity** should be maintained at levels sufficient to sustain at least commitments within 1-year time period
- **Reputational, fiduciary risks** and environmental misses are not tolerable
- **Operational risk** will be **actively monitored and minimized** through adequate controls and processes to eliminate potential sources of errors and frauds that might harm AfDB

Operationalization of the risk appetite

To ensure integration of AfDB's overall risk appetite into daily business processes, a proper portfolio diversification and an efficient use of capital, **operational limits for each risk category will be defined** and specified in the Bank's risk management policies and guidelines; the most relevant include:

Credit Risk:

- **Global country limit** (whose value will vary from country depending on each country rating and income level)
- Within the private sector portfolio (i) **single country limits**, (ii) **single sector limits and** (iii) **single obligor limit**

Market risks:

- **Total risk capital utilization limit** for market risks
- **Target average credit rating** for the treasury portfolio
- **Eligibility criteria for treasury portfolio** securities
- **Asset and Liability sensitivity limits** for Interest rate and currency risks

Liquidity risk:

- Eligibility criteria for "liquid" assets
- Prudential Minimum Liquidity requirement over 1-year time horizon
- Medium and long-term **structural liquidity** limits

Operational risk:

- Operational risk limits to be defined according to relevant dimensions of operational risk mapping (event types, business lines), when operational loss data are collected and risk measures are available.

The overall risk tolerance and all limits will be revised and submitted to the Board for approval; (i) whenever a new Medium Term Strategy is formulated, (ii) if a general capital increase or a call for callable capital occurs, or (iii) the Board or Risk find it relevant to review the statement due to major changes in the financial markets. Operationalization limits will be submitted to SMCC for approval.

CREDIT RISK COMMITTEE IN SELECTED MULTILATERAL DEVELOPMENT BANKS

	GLOBAL	EUROPEAN MDBs			REGIONAL MDBs		
	IFC	EBRD	EIB	COEDB	IADB	ASDB	AFDB (proposal for CRC)
Is there a specific CRC, body or group exclusively in charge of risk issues	NO	NO	YES Credit Risk Assessment Group	YES Credit Risk Committee	YES Quality and Risk Review Committee	NO	YES Credit Committee
If not, where are risk issues discussed	Investment Review	Operations Committee	-	-	-	Investment Committee	-
Is there a secretariat to support the CRC	NO	YES Composed by three members (operations, risk and legal)	YES (Operated by the Risk Department)	NO	NO	YES Investment Committee Secretariat composed by four members (representative of Risk Management, operations, legal)	YES (operated by the Risk Department)
Composition of the CRC, body or group in charge of Risk Issues Or Composition of the final decision body	> Industry Director > Regional Director > Investment Officer > Industry Expert > Credit Officer > Lawyer > Environmentalist > Insurance expert > Resources & Mobilization officer	>First Vice President > Vice President Finance > Vice President Risk Management > Managing Director for Monitoring > General Counsel > Chief Economist > Director of Risk Management	>Chaired by Director of Operations >Risk Director >Director of Finance > Director of Controlling > Chief Economist	> Governor > Three Vice-Governors > Director of Treasury >Director of Operations > General Counsel > Chief Risk Officer > Compliance Officer	>General Manager of the Non-Sovereign Guaranteed Operations Department (NSG). >Risk officer assigned to the transaction, >Representative from Legal > Representative from finance, > Representative from environmental and social > Representative from country > Other representatives from NSG, including syndication, and portfolio management.	>Vice President of Private Sector and CoFinancing Operations >VP Operations > Managing Director > General Counsel > Director for Private Sector Operations > Director General for Regional and sustainable Development > Director of relevant regional departments > Head of the office of the Risk Management	Head of Risk Management - Chair - Director of FTRY - Director of FFCCO - Legal Counsel - Division Manager Credit Risk Division - Risk technical Expert/s other/s than the credit officer at origination
Which is the final decision body before Board	Investment Committee	Operations Committee	Management Committee	Credit Risk Committee	Operations Policy Committee	Investment Committee	Operations Committee
Veto power from Risk Final decision	NO If no agreement, decision is brought to VP for resolution	NO But risk has "de facto" veto power at Operations Committee	NO But Management Committee very rarely overrules Risk's decision on credit approval	YES	No formal "go-no go decision" from QRM but any unresolved disagreements over credit risk can be taken up to the Operations Policy Committee for resolution	NO	NO The Credit Risk Committee decision could be override by OpsCom
Who is the maximum authority in Risk	Vice President of Risk	Vice President Risk	Credit Risk Directorate	Chief Risk Officer	Office of Risk Management (RMG)	Office of Risk Management (ORM)	Head of Risk
Reporting of the maximum authority of risk	President	President	Vice President	Directorate of Control and Systems	President	President	President

CREDIT RISK COMMITTEE

SCOPE OF RISK RESPONSIBILITIES AND OVERSIGHT

The Terms of Reference of the Credit Risk Committee (CRC) provides the full scope of areas of focus and responsible institutional organs which will be tasked to discharge and monitor the related activities.

TERMS OF REFERENCE

The Credit Risk Committee (the committee) is established to ensure effective and efficient credit decision process such that each credit transaction is adequately and properly reviewed and assessed before final approval.

Roles and responsibilities

The responsibilities of the Credit Risk Committee include, but are not limited to the following:

Non-sovereign Transactions – credit approval process

- Review and provide guidance on proposed non-sovereign transactions at the final review stage including the validation of the security package or collateral and approve credit risk recommendations.
- Ensure that appropriate level of due diligence and analysis for each credit transaction is performed.

Sovereign operations

- Approve country ratings and country risk notes.

Exposure and Portfolio Management

- Ensure compliance with statutory and operational limits as well as setting additional reasonable prudential limits on specific credit and market instruments that have embedded credit risks.
- Review portfolio evolution and approve changes in the country and project credit ratings proposed by the COWG and NSCRWG respectively.
- Approve changes to projects, such as waivers and covenants after Final Review at pre or post signature upon recommendation from GECL.
- Review all proposals on work-outs or troubled debt restructuring. The CRC endorsement is required before such proposals are submitted to the President for clearance to the Board.
- Approve provisioning and write-offs recommended by the NSCRWG.

- Approve equity exits proposed by operation teams.

Guidelines and policies

- Provide guidance, issue recommendations and approve credit risk policies and guidelines presented by the NSCRWG.

Accountability and reporting

- The Committee is accountable to the Head of Risk.
- There will be an annual assessment of the Committee's overall effectiveness.

Membership

- The membership is determined on the basis of the functional expertise and institutional responsibility to perform the activities listed in figure 08.
- The Chairperson, who is accountable for the effective operation of the Committee in achieving its mandate, will be appointed by the President.
- The members of the Committee shall be appointed by the President, based on considerations of relevance of experience and skills.
- The Committee shall also appoint non-voting members, comprising specialists from various departments of the Bank (ORVP, OSVP, OIVP...) when considered by the Chair.
- The members of the Committee are accountable for representing the wide interests of the Bank and shall declare any conflict of interest in advance of the meetings and the Chair will advise the conflicted parties when not to participate, as well as appropriate use of certain information.

Meetings

- New transactions shall be presented to the Committee by the task manager at origination from OPSM. NSCRWG and COWG reports shall be presented to the Committee by the chairmen of these groups or designated appointees.
- The Committee will generally meet once a week. Additional meetings may be convened to the extent that there are agenda of items to be presented.
- In the event that the Chairperson is absent, he/she shall designate one of their members to chair a meeting. Each Committee member is responsible for arranging an Alternate to represent him/her if he/she is unable to attend a meeting. Such Alternate shall be fully empowered to act on behalf of the member.
- Quorum consists of the Chair (or Alternate Chair) and other 3 voting members of the Committee.
- Decision making will be based on consensus.

- All the meetings of the Committee shall be formally documented in minutes format and distributed to members prior to the next meeting.

Secretariat support

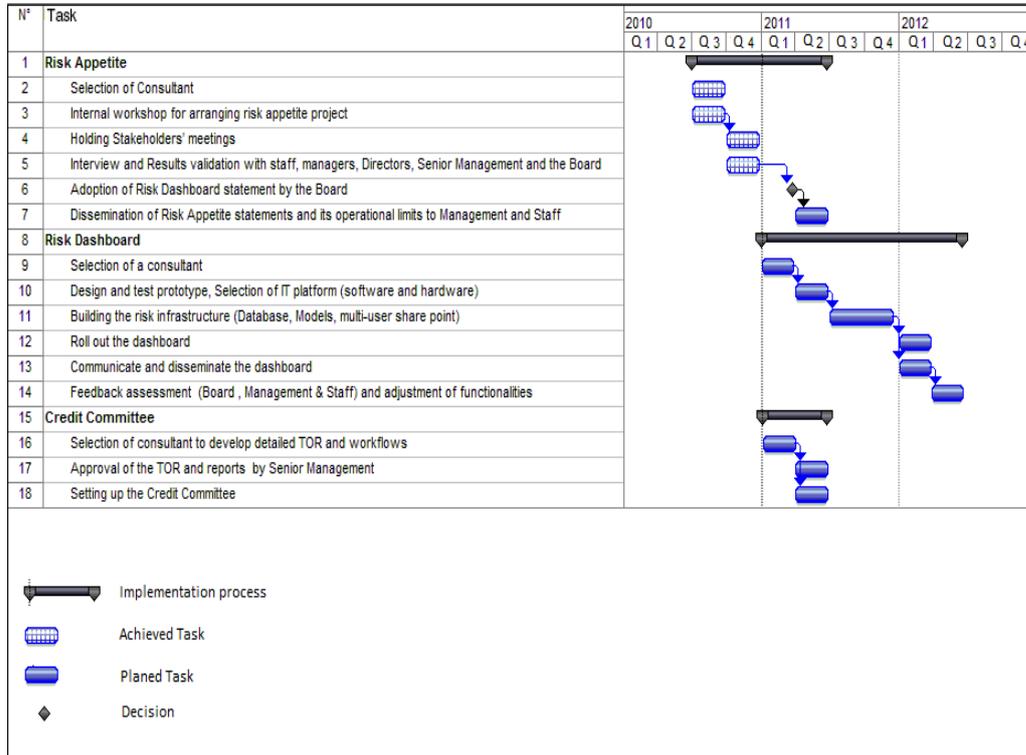
- FFMA shall provide secretariat services to the Committee.
- The secretariat support to the Chair and the Committee will include the development of meetings agenda,, dissemination of Committee material, and advice/guidance on Committee procedure to facilitate the effectiveness of its operations.
- The Secretariat recommends whether a new transaction should be considered for discussion at the Committee or validated on a “non-objection” basis. The decision to include a transaction for discussion shall be based on the degree of risk rating, complexity, innovative features, size, terms of negotiation or any other issue requiring the attention of the members.

Interaction between the credit risk committee and other decision bodies of the Bank

- All recommendations from the Committee regarding new transactions for the non-sovereign portfolio will be presented to the Operations Committee Secretariat. OpsCom has the authority to overrule any decision taken by the Committee based on strategic or development considerations. Any override decision should be clearly documented by the OpsCom Secretariat to the Board.

- The Committee decisions related to proposals received from the NSCRWG and COWG in relation to rating changes, work-outs, provisioning and write-offs are final.
- The Committee recommendations for restructuring and changes in conditions received from GECL are final.
- The Committee recommendations on policies and guidelines shall be endorsed by the respective decision body (ALCO, the Board...).
- The Credit Risk Committee does not interact with the Board for the conduct of its operations. However, a formal written report of the Committee's performance and effectiveness shall be prepared annually for the Operations Committee and the Board.

IMPLEMENTATION TIMELINE



RISK APPETITE STATEMENT – OTHER MDBs

Although all MDBs strive to foster economic development in their regions of operations, but differ in terms of: (i) their strategic priorities and focus on the public and private sectors, and (ii) capital base and replenishment process; it can be expected that the risk appetite statements would be different. Therefore benchmarking in this area has relatively limited relevance in terms of specific risk appetite statement and related metrics. The above notwithstanding, Table A.5.1 provides the profile of a peer MDBs.

Generally, the full scope of risk appetite is not publicly disclosed. Some of the broad risk appetite statements of other MDBs are shown in the box below and are quite similar to the Bank. Table A5.1 provides a sample of a typical risk appetite statement of an MDB.

Table A5.1: Sample of Risk Appetite Guideline - MDBxyz

Risk Appetite	Area	Metric	Limits & Cut-offs
Maximum Exposure	Private Sector Operations	Share of Total outstanding portfolio	XX%
	Financial Sector (Secured %Unsecured debt, Subordinated debt, SME, etc) by risk rating category	Share of financial institution effective capital	40% for Invest grade or higher; 30%-35% strong to very strong; 205-25% for satisfactory to fair; 15% for week.
Cuff-of Rating	Single Currency Loans	Minimum credit risk rating	Fair (B+/B- on Moody's rating scale)
	Special Products	Minimum credit risk rating	Weak (B/B2 on Moody's rating scale)

Quotes



- “The Bank’s capacity to assume more risk needs to be exercised in a controlled manner, **in order to maintain its AAA rating and status as prime issuer on the capital markets**”



- “The Bank’s policy is to limit the total amount of outstanding loans and guarantees to its paid-in capital stock plus the general reserve and the callable capital of the non-borrowing member countries”
- “Since 1962, **the Bank has held the highest possible triple-A credit rating**”



- “IFC is required to maintain a minimum level of total resources (including paid-in capital, total loss reserves and retained earnings, net of designations) equal to total potential losses for all on- and off-balance sheet exposures **estimated at levels consistent with the maintenance of a AAA rating**”

SOURCE: MDB’s annual and financial reports

McKinsey & Company