ADB

Asian Development Bank

Memorandum

Office of the President

15 November 2023

To: Emmanuel Y. Jimenez
Director General, IED

15 Nov 2023

From: Woochong Um
Managing Director General

Subject: **Management Response to IED's Corporate Evaluation of ADB's Investment and Credit Risk Management of Nonsovereign Operations, 2009–2021**

A. General Comments

1. Management welcomes the report on the Corporate Evaluation of ADB's Investment and Credit Risk Management of Nonsovereign Operations (NSO) of the Independent Evaluation Department (IED). This evaluation is timely given several strategic initiatives are already underway, including the comprehensive NSO business process reforms. The findings of IED will help inform these efforts.

B. Response to Recommendations

2. **Recommendation 1: ADB can further clarify its willingness to take risks in NSO, incorporating its development mandate as an MDB, to inform internal and external stakeholders. For operations teams, ADB can implement and widely disseminate differentiated risk guidance frameworks as agreed amongst relevant stakeholders. ADB can detail the risks that it is willing to take under its developmental mandate to clarify the circumstances under which ADB, for example, is willing to provide longer tenors, take on more country or political risk, or provide funding to industries where others would not take such risk.**

> ***Management agrees.*** The risk appetite for NSO is captured in the Capital Adequacy Framework, Exposure Limits on Nonsovereign Operations, and Private Sector Operations (PSO) Operational Plan. These documents detail the risk appetite of NSO as it relates to country and industry exposures, among others. To supplement these institutional documents and to further clarify the willingness of ADB to take risks in NSO, the first set of risk appetite frameworks covering renewable energy, corporates, financial institutions, and non-bank financial institutions is under development. Other risk appetite frameworks will be produced as needed. ADB is also formulating an investment framework for nonsovereign operations that will further detail investment objectives (developmental and commercial), risk appetite and tolerance for risk factors related to investment activities, and a target portfolio. This framework will direct and complement the portfolio approach of ADB to NSO, which balances risk, financial sustainability, and development impact.

3. **Recommendation 2: ADB risk management stakeholders can agree on additional quantifiable key performance indicators and use them to align incentives for operations and risk teams. The indicators can be included in ADB management performance evaluations, cascaded to staff for incentives and accountability and integrated into department workplans with annual institutional targets. Progress in achieving the targets can be reported annually.**

Management agrees to introduce certain key performance indicators (KPIs) to align incentives between operations and risk teams. Such KPIs should support an overall client-centric approach. Shared targets need to be carefully selected and defined so as not to dilute the independent oversight role of the Office of Risk Management (ORM) as the second line of defense. While credit quality indicators could reasonably be shared, transaction volume and transaction number targets should not be shared in order to preserve the independence of ORM.

4. **Recommendation 3: ADB needs to continue to improve its processes to elevate its responsiveness to clients. It can do so by taking stock of the steps needed and the departments involved in approving transactions, identifying the key bottlenecks that delay transaction approval and the main reasons for deal mortality, and adopting risk-based approvals. ADB can delegate authority based on risk levels to investment staff to reduce processing times.**

Management agrees that additional process reforms are required to increase the efficiency, responsiveness, and relevance of ADB to its clients. This is a key principle underpinning the ongoing NSO Business Process Reform project which seeks to put in place fit-for-purpose processes, documentation, and governance for NSO. Management notes that an important milestone was achieved with the recent conclusion of phase one and corresponding revisions on 1 September 2023 to the OM D10 Staff Instruction. Management is committed to continuous process improvement, including behavioral changes, to drive reform efforts. While ADB will continue to track cancellations (and terminations) and their underlying causes, the suggestion to pre-screen transactions is not implementable as cancellations initiated by the client are difficult to anticipate in advance. Moreover, cancellations triggered by ADB may be justified by credit deterioration, for example in a workout scenario to eliminate undrawn limits, or other commercial considerations.

5. **Recommendation 4: ADB should set clear guidelines for operations teams for pricing nonsovereign transactions. Such guidelines can detail the process for transaction pricing and identify the situations where ADB uses market pricing, cost recovery pricing or a combination.**

Management disagrees that detailed guidelines on how to price transactions would speed up decision-making and takes the view that a principles-based reference to relevant benchmarks and objectives is more appropriate. Pricing inputs from commercial lenders are considered good benchmarks, while pricing inputs from development finance institutions are more of a supporting indicator. ADB also seeks to ensure that risk is priced appropriately to achieve NSO sustainability through a cost recovery assessment of each transaction. The more limited the quality of the market pricing discovery, the more important the NSO pricing tool becomes for the pricing decision of ADB. Management highlights the importance of the introduction of the pricing annex in 2021 in support of transparency and speed of decision-making. It has improved the robustness of the market price discovery process and serves as the key determinant of NSO transaction pricing.

Management further notes that with the launch of the updated pricing tool on 1 November 2023, additional guidance was provided to the staff of Private Sector Operations Department (PSOD) and ORM.

6. **Recommendation 5: ADB's cost recovery pricing model for nonsovereign transactions needs to be updated, agreed upon, and operationalized, and return targets for the nonsovereign debt business should be a deliberate strategic choice.**

Management agrees. An update of ADB pricing tool became effective on 1 November 2023. The parametric update includes a new output field indicating the risk adjusted return on capital (RAROC) associated with a particular credit spread. The new output field is expected to support strategic discussions on pricing and portfolio returns. The tool will continue to be reviewed and updated annually. Return hurdles and targets based on RAROC for debt and internal rate of return for equity are now being considered.

7. **Recommendation 6: ADB should fully implement and mainstream the management information and IT systems for management to seamlessly share information and make effective decisions. A one-stop shop in ADB should be given the responsibility to monitor and integrate portfolio metrics, supply the associated performance narrative to senior management and the Board, and coordinate the metrics' incorporation into budgets and strategies.**

Management agrees with the need for information systems that enable it to make effective data-driven decisions. The NSO Change Program (comprised of all NSO stakeholders) can develop the processes and information technology platform to enable the establishment of a one-stop shop that monitors and integrates portfolio metrics and supplies the performance narrative. NSO stakeholders can coordinate the establishment of the one-stop shop and the incorporation of respective metrics into budgets and strategies can be undertaken by individual departments.

cc: The President
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