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Independent Evaluation ADB

Evaluation Approach Paper

Corporate Evaluation of ADB's Investment and Credit Risk Management of Nonsovereign Operations (2009–2021)

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A. Introduction

1. **This paper sets out the approach and methodology for a corporate evaluation of Asian Development Bank's investment and credit risk management of nonsovereign operations (NSO).** The Asian Development Bank (ADB) undertakes NSO to provide financing to eligible recipients for the benefit of developing member countries (DMCs). Nonsovereign operations comprise the provision of any loan, guarantee, equity investment, or other financing arrangement to privately held, state-owned, or subsovereign entities.[1] ADB's support for the private sector through NSO has grown considerably over the past decade, being a key component of Strategy 2020 and Strategy 2030.

2. **With the expected increase in the number, volume, and complexity of its private sector operations, it is important for ADB's investment and credit risk management to be timely, robust, and effective in identifying, quantifying, managing, and mitigating NSO risks**. This will enable ADB to meet its' dual mandate under Strategy 2030 of ensuring ADB's profitability and commercial sustainability while pursuing development impact in DMCs—as commercial success is correlated with development outcomes. This is particularly important since ADB's private sector operations are expected to reach one-third of its total operations in number by 2024. In addition, ADB wants its private sector operations to (i) increase its presence in other sectors such as agribusiness, health, and education, and (ii) expand in new and frontier markets, including challenging markets such as Fragile and Conflict-Affected Situations (FCAS) and Small Island Developing States (SIDS).

3. **Investment and credit risks at ADB are likely to increase due to external factors and ADB's internal strategy to expand NSO which are inherently riskier than sovereign operations.** The continued economic effects from the COVID-19 pandemic and the recent Russian invasion of Ukraine have also increased credit, country and investments risks in Asia and the Pacific region. This evaluation will provide relevant stakeholders with a perspective on the ability to manage this increase in risk.

4. **In this evaluation, the Independent Evaluation Department (IED) will undertake an examination of ADB's investment and credit risk management of NSO covering the period 2009–2021.** The evaluation will seek to assess the relevance and effectiveness of ADB's investment and credit risk management policies, processes, tools, systems, and organization. It

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[1] In each case, (i) without a government guarantee; or (ii) with a government guarantee, under terms that do not allow ADB, upon default by the guarantor, to accelerate, suspend, or cancel any other loan or guarantee between ADB and the related sovereign.

will also look at how risk management activities have progressed and performed in support of the Private Sector Operations Department's (PSOD) priorities towards achieving ADB's Strategy 2030 and broader development objectives. The evaluation will not include risk management activities covering treasury and operational risk.

B. ADB's Approach to Investment and Credit Risk Management

5. **ADB employs a three lines of defense model consistent with Basel guidelines to mitigate risk.** The first line is private sector operations, the second is risk and the third is audit. In this model, PSOD, supporting departments (e.g., Controller Department, Office of General Counsel, Information Technology) and the Office of Risk Management (ORM) are jointly responsible for undertaking investment and credit risk management of NSO together with the audit function.[2]

6. **PSOD and supporting departments are the first line of defense.** PSOD's origination divisions interact with ADB clients to identify projects and gather information needed for the assessment of risks. PSOD then prepares an initial risk assessment and rating of the proposed project with relevant input from these departments. The assessment is submitted to ORM for review, comment, and approval of the rating. Responsibility for the project is transferred to the Private Sector Portfolio Management Division (PSPM) within PSOD during implementation for preparing monitoring reports with updated risk ratings to be reviewed by ORM. PSPM manages all debt and guarantee transactions. The Equity Investment Unit (EIU) and the Private Sector Investment Funds and Special Initiatives Division (PSIS) within PSOD originate and manage the equity portfolio. PSOD collaborates on these workout and recovery activities with ORM's Remedial Management Unit.

7. **ORM is the second line of defense.** ORM's mandate is to work with operating departments to ensure that ADB's goal of poverty alleviation is sustainable through (i) safeguarding ADB's AAA credit rating, (ii) advising Board and management on risk issues, and (iii) promoting a strong risk culture throughout the institution. To accomplish its goals, ORM undertakes various activities in support of NSO: (i) establishes and maintains policies, procedures, and tools for risk management that are consistent with prudent banking principles and those of other MDBs; (ii) identifies, assesses, and quantifies the risks of all new transactions in order to provide independent recommendations to the Investment Committee (IC); (iii) provides an independent perspective on the NSO portfolio through periodic review and monitoring of individual transactions (rating adjustments, valuations, handling of waivers and amendments, maintenance of a watch list); (iv) supports timely recovery action on deteriorating credits; (v) identifies, assesses, and quantifies the market, counterparty, and liquidity risks of ADB's treasury portfolios; analyzes ADB's portfolio returns; and ensures compliance with established treasury and investment risk guidelines; and (vi) identifies, measures, monitors and reports operational risk in a structured and disciplined approach across organizational lines.

8. [Confidential information deleted.]

9. **ADB's investment governance process for new NSO commitments requires coordination and consensus among senior management in PSOD and ORM.** At preliminary review and concept review, a decision is taken on the basis of summary facts and analysis whether to allocate the substantial staff time and other resources for full due diligence. Following

[2] The audit function is not included in the scope of this evaluation.

transaction review, a final review is prepared and presented to the Investment Committee (IC) which then endorses a transaction to the President and the Board for final approval, as required.[3]

C. Focus Areas of Investment and Credit Risk Among Multilateral Development Banks

10. **The principal peer Multilateral Development Banks (MDBs) of relevance to ADB's NSO operations will be primarily the International Finance Corporation (IFC) and the European Bank for Reconstruction and Development (EBRD).** Best practices from other MDBs may also be included. In addition, this evaluation will benchmark ADB operations against other commercial financiers with best practice standards.

11. **Precedent evaluations of MDB credit risk management functions are not readily available other than a limited evaluation note prepared in 2011 by the Inter-American Development Bank's Office of Oversight and Evaluation (OVE).** Overall, OVE found generally positive results from that assessment which are listed in Attachment 1. Although the Oversight Note is dated, both the subject matters stressed and the specific findings are ongoing matters of attention for comparator institutions.[4] Therefore, this section is currently based on preliminary information available on risk management precedents and interactions among MDBs.

12. **Key shared traits of ADB and MDB comparators include development focus calling for continuous innovation, operations across many countries, and a focus mainly on sub-investment grade credit and equity**. These features shape comparator institutions' staff needs, cost structure, cultures, and processes, which display many similarities. Comparator institutions will have implemented most or all of the required basic risk frameworks elements and tools. MDBs' development mandate generates a continuing need to explore investments in new industries, new products, and new market segments. Therefore, expertise and risk frameworks must continuously evolve to keep pace with development priorities.

13. **The risk and credit leadership of comparator institutions communicate regularly on the risk environment, their respective risk operating models, and areas of common concern.** Staff consult to learn from the experience of other MDBs and the private sector, and to benchmark their operations against peer institutions. Topics of discussion in these consultations have included:

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[3] ADB's Concept Review Committee, which approves NSO transactions at concept review stage, is comprised of the director general of PSOD and the head of ORM. The former represents business while the latter represents risk. ADB's Investment Committee, which approves transactions at the final review stage, is comprised of the vice president for private sector and public–private partnership, the vice president responsible for the geographical region where the transaction is located, the vice president for finance and risk, the general counsel, the director general of PSOD, the director general of the Sustainable Development and Climate Change Department, the director general of the relevant regional department and head of ORM. This process does not apply to post-Board approved NSO Program exposures (i.e., MFP, TFP, and SCFP). For Board approval, Management recommendation based on IC endorsement is required.

[4] Although Inter-American Development Bank (IADB) is not subject to the principles for the management of credit risk issued by the Basel committee for banking supervision, the note provides a summary of each one of the seventeen Basel principles divided into five categories: (i) the credit risk environment (Principles 1–3); (ii) the credit granting process (Principles 4–7); (iii) the credit administration, measurement, and monitoring process (Principles 8–13); (iv) the credit risk controls (Principles 14–16), and (v) the supervisory framework (Principle 17). The Principles for the Management of Credit Risk prepared by the Basel Committee on Banking Supervision (BCBS) can be found at: The Basel Committee - overview (bis.org).

(i) internal structure and staffing of investment and credit risk functions;
(ii) authority of credit over the investment decision and pricing;
(iii) lengthy average times between investment concept clearance and transaction closing;
(iv) relations with operations departments, especially regarding the quality and clarity of investment proposals;
(v) efforts to develop differentiated processes and delegate decision making authority away from Boards and top management;
(vi) managing overall portfolio risk and building capital needed for growth while moving into riskier sectors, products, and geographies, and to do smaller deals that are costly to book;
(vii) efforts to agree and document deal acceptance criteria, especially in new business areas and for new products;
(viii) strengthening the portfolio monitoring and review functions; and
(ix) improving data systems and system integration.

D. ADB's NSO Portfolio

14. [Confidential information deleted.]

15. [Confidential information deleted.]

16. [Confidential information deleted.]

17. [Confidential information deleted.]

18. [Confidential information deleted.]

19. [Confidential information deleted.]

E. Theory of Change

20. [Confidential information deleted.]

21. [Confidential information deleted.]

22. **The outcomes are divided into short-term outcomes and intermediate outcomes.** Short-term outcomes are the immediate desired results of an effective investment and credit management system such as: (i) improved transaction approval time, (ii) improved quality and accuracy of ratings, (iii) improved response time to client requests, (iv) maximized recovery of impaired investments, and (v) improved risk framework. Intermediate outcomes are the higher level and longer-term outcomes, and these are: (i) maintenance of ADB's AAA credit rating, (ii) enhanced financial stability and sustainability, and (iii) expanded private sector operations in line with Strategy 2030 priorities.

F. Evaluation Scope

23. **The evaluation will cover the NSO's approved and committed during 2009–2021.** The portfolio coverage starts in 2009, when project ratings templates were introduced. This was

also the year when the Office of Risk Management was created. The evaluation will not include credit assessment of post-Board approved NSO Programs (TFP, SCFP, and MFP). [5]

24. **The evaluation report is intended to inform the Board and Management discussion of the extent and nature of ADB's investment and credit management, given the bank's focus on expanding support for nonsovereign operations.** The evaluation will draw lessons from experience and make recommendations to improve ADB's investment and risk management system and to help enhance the success of ADB's nonsovereign operations. It will seek to understand the current risk culture within ADB and gauge the alignment in risk appetite across the organization.

G. Evaluation Questions

25. The evaluation will identify areas in which the investment and credit risk management function has performed well and areas for improvements and determine if the Office of Risk Management and related departments have the right structure and resource to effectively support the delivery of ADB and PSOD's priorities such as Strategy 2030.

26. **Overarching Question:** Has ADB been relevant and effective with its approach to nonsovereign investment and credit risk management, and how have these activities progressed and performed in support of ADB's strategic priorities and overall development objectives?

27. **Specific Questions:** The overarching questions will be underpinned by the following sub-questions:

(i) How relevant were/are ADB's investment and credit risk management policies and practices to meeting ADB's strategic priorities?

(ii) How effective was ADB's investment and credit risk management of nonsovereign operations (at approval, implementation and exit of interventions) in addressing internal and external client needs?

(iii) Is ADB well-equipped to deliver long-term and sustainable results with its existing investment and credit risk management structure?

28. The detailed evaluation matrix is in Attachment 3.

H. Methodology—Components and Activities

29. The evaluation will use mixed methods to gather evidence. It will include: (i) an ADB Policy and Processes Framework review, (ii) an ADB NSO portfolio review, (iii) desktop country case assessments, (iv) an assessment of ADB's organization for delivery, (v) comparator review, and (vi) interviews and surveys of ADB staff and stakeholders. Below is a general description of each of these methods.

30. **ADB Policy and Processes Framework**: This will be a desk examination of existing policies, procedures, tools, and systems used by NSO. This exercise will involve, but will not be limited to: (i) a review of the adequacy of all applicable policy, staff instructions, guidelines and strategies for investment and credit risk management of NSO in ADB; and (ii) interviews of ADB staff from all the departments involved in a typical NSO transaction project cycle.

[5] [Confidential information deleted.]

31. **ADB NSO Portfolio Review:** This will be a desk review of project documents and will utilize and build upon existing data and analysis available from the departments involved in risk management activities. As possible, the evaluation will seek to:

(i) assess end-to-end processing steps and timelines for investment and credit decisions;
(ii) undertake a qualitative review of selected approval, monitoring, waiver, and settlement notes to assess overall quality;
(iii) perform a credit ratings migration analysis;
(iv) compare agreed transaction pricing with market pricing and outputs from the cost recovery pricing tool;
(v) review changes in credit ratings and provisioning decisions and the timing of project transfers to the Remedial Management Unit;
(vi) understand the portfolio metrics used for equity investments, including return targets and the selection of performance benchmarks; and
(vii) qualitatively assess the process for determining the timing of equity investment exits on an illustrative basis.

32. **Case Assessments**. There will be an assessment of relevant transactions to provide perspective on key themes such as the relations between the first and second lines of defense, the quality of work product at origination and during monitoring, and issues within portfolio segments.

33. **ADB's organization for delivery.** The evaluation team will review the institutional arrangements within ADB for ensuring investment and credit risk management of NSO at all stages of the transaction (transaction approval, monitoring and management, and workout and recovery). This includes a review of the coordination and collaboration between ORM, PSOD, and other operating departments in identifying gaps. The evaluation will also determine whether risk management at ADB is adequately resourced and aligned with NSO priorities to make accurate and timely decisions on approvals and transaction developments.

34. **Comparator review**. As noted above in para. 10, the principal peer MDBs of relevance to ADB's NSO operations are IFC and EBRD. This section will benchmark ADB against these and other appropriate comparable institutions. This is expected to be done by means of interviews with ADB staff and staff of comparator MDBs, and a desk review of publicly available data.

35. **Interviews and surveys of ADB staff and ADB clients**. The evaluation team will conduct semi-structured interviews and appropriate surveys of the Board, management, and staff in order to understand risk culture and alignment of risk appetite within the institution. The purpose is to solicit their experience in all areas of the review but focused particularly on the clarity of ADB's risk appetite, risk culture, relations between the first and second line, perceptions of work product quality throughout the investment life cycle, accountability for quality and decision making, and perceptions of tools and systems.

36. **Limitations.** Due to the COVID-19 pandemic, stakeholder interviews will mainly be conducted virtually via video conference calls. To offset the limitation of country and project site visits, the team will use more local consultants to collect information, conduct interviews with sample stakeholders and clients as required. When possible, simple web-based survey instruments will be used as well. The evaluation coverage will depend on the availability of data and access to data both within ADB and comparator institutions. Changes to systems, tools, and metrics employed over the review period will factor into the extent of possible analysis.

I. Evaluation Process and Timeline

37. The evaluation is expected to commence in September 2022 and be completed with the final report submitted to the Development Effectiveness Committee (DEC) in third quarter of 2023. A tentative implementation timetable is presented in Table 1.

Table 1: Proposed Timeline

Activity	Tentative Schedule
Approval of Approach Paper	Aug 2022
Missions	Nov 2022 – Feb 2023
Interdepartmental circulation	May 2023
IED Director General Approval	Aug 2023
Board Circulation	Aug 2023
DEC meeting	Sep 2023

DEC = Development Effectiveness Committee, IED = Independent Evaluation Department.
Source: Asian Development Bank (Independent Evaluation Department).

J. Resource Requirements

38. The evaluation will be carried out by an IED team: Gloria Paniagua (Senior Evaluation Specialist and Co-Team Leader), Faraz Kazmi (Senior Evaluation Specialist and Co-Team Leader), Alex Wellsteed (Principal Evaluation Specialist), Ambra Avenia (Evaluation Specialist), and Conney Funtanar (Evaluation Assistant), under the supervision of Nathan Subramanian (Director, IESP). The team will be assisted by international and local consultants recruited in accordance with ADB Procurement Policy (2017) and associated procurement staff instructions.

39. The approach paper was peer reviewed by Betsy Nelson, former Vice President and Chief Risk Officer, EBRD; Martin Kimmig, former Chief Risk Officer, Asian Infrastructure Investment Bank; and Enrico Pinali, Principal Operations Specialist, ADB. Internal commenter is Paolo Obias, Principal Evaluation Specialist.

Attachments:
1. Findings from Inter-American Development Bank (IADB) Oversight Note on Credit Risk Management
2. Details of ADB’s NSO Portfolio
3. Evaluation Matrix

FINDINGS FROM THE OVERSIGHT NOTE ON CREDIT RISK MANAGEMENT

(prepared by IADB's Office of Oversight and Evaluation)

1. The Bank has defined a risk tolerance towards non-sovereign guaranteed operations (NSG) but has yet to define its NSG risk appetite. 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.

2. 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.

3. The Bank has made good progress by creating the Office of Risk Management (RMG), but it has yet to define clearer rules for RMG's engagement during the loan/guarantee assessment process.

4. 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.

5. The review finds that the Credit Risk Classification System (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.

6. The Bank's Portfolio Management Unit effectively discharges some monitoring responsibilities but falls short of those required for a proactive management of the portfolio.

7. 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.

DETAILS OF ADB'S NSO PORTFOLIO

[Confidential information deleted.]

EVALUATION MATRIX

[Confidential information deleted.]