Corporate Evaluation

ADB's Investment and Credit Risk Management of Nonsovereign Operations, 2009–2021

Independent Evaluation ADB

Raising development impact through evaluation

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NOTE

In this report, “$” refers to United States dollars.

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Abbreviations

ADB	–	Asian Development Bank
IT	–	information technology
MDB	–	multilateral development bank
NSO	–	nonsovereign operations
ORM	–	Office of Risk Management
PSOD	–	Private Sector Operations Department
RAROC	–	risk-adjusted return on capital

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IED remains fully responsible for the report’s contents.

Foreword

The leveraging of private sector expertise and funding is becoming increasingly important because of the large amounts of capital required to meet member country objectives such as sustainable growth, poverty alleviation, and climate change mitigation and adaptation. To implement its ambitious plans for private sector participation and growth in member countries, the Asian Development Bank (ADB) must manage investment and credit risks in a timely, robust, and effective way to identify and mitigate risks of its committed nonsovereign portfolio. Risk management and avoidance of undue credit losses is critical for ADB to invest in catalyzing private sector involvement in member countries on a sustainable basis.

This corporate evaluation by the Independent Evaluation Department assessed ADB's investment and credit risk management of nonsovereign operations during 2009–2021. It found that ADB substantially progressed during the evaluation period. Several changes to the risk management organizational structure have been successfully implemented. Transaction processing times have been reduced through new approaches and some processes have been improved. New risk management tools and systems have been implemented and existing approaches updated and improved. These changes have helped ADB largely achieve its key risk objectives while retaining ADB's AAA rating status, managing its nonperforming loan indicators to be in line with peer institutions, and keeping actual credit losses low.

Nevertheless, the evaluation found several areas for improvement. ADB does not clearly define the risks that it is willing to take in nonsovereign operations, including under its development mandate. It does not have an agreed set of quantifiable key performance indicators and targets to align incentives, such as return-based targets. It is still in the process of implementing an end-to-end management information system to identify the main processing bottlenecks and provide consolidated information to decision-makers. Its cost recovery model does not apply the most updated assumptions, and pricing guidelines are not clearly communicated to operations teams in a consolidated document.

To improve risk management, the evaluation recommends that ADB further clarify the risks that it is willing to take in nonsovereign operations under its development mandate, continue to increase the efficiency of transaction approval and monitoring processes, and implement and track more performance targets to align incentives for its operations and risk teams. Additionally, ADB can clarify pricing guidelines and make further progress toward an end-to-end management information system to enable better informed and quicker strategic decisions.

Emmanuel Jimenez
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Executive Summary

With the targeted increase in the number and complexity of its private sector operations, Asian Development Bank (ADB) investment and credit risk management must be timely, robust, and effective in identifying, quantifying, managing, and mitigating nonsovereign operations (NSO) risks. The evaluation covers 2009–2021 and answers the questions: "Has ADB been relevant and effective with its approach to nonsovereign investment and credit risk management? And how have these activities supported ADB's strategic priorities and overall development objectives?"

Much Progress to Date

ADB implemented several organizational changes. The first major reform ADB initiated to improve its investment and credit risk management capability was to create an independent risk unit in 2005 and upgrade it in 2009 to the Office of Risk Management (ORM). ADB bolstered its first and second lines of defense. For instance, it merged the credit assessment and monitoring functions in ORM and divided the staff into two divisions to deepen its sector specialization. ORM created sector teams with corresponding credit specialists in each division, and the Private Sector Operations Department (PSOD) created specialized sector and product teams, units, and divisions. And to cope with the growing number and diversity of NSO, ADB hired more PSOD and ORM staff with diverse skill sets and expertise.

To reduce transaction processing times, ADB streamlined the credit approval process in 2015 and 2016. It introduced the Faster Approach to Small Nonsovereign Transactions in 2015 to expedite the approval of small NSO deals. It replaced the eight-member Investment Committee with the two-member Concept Review Committee to approve concept papers. It skipped concept reviews for follow-on investments and additional financing. And it approved concept review papers by circulation if the Concept Review Committee decided that a meeting was unnecessary. [Confidential information deleted].

ADB also enhanced its risk management tools and systems. Its rating scale has remained unchanged since 2009, but credit-rating templates have been updated to improve the risk assessment of certain transaction types. It introduced a pricing tool in 2010 to facilitate more informed pricing decisions for debt transactions. PSOD launched the pricing annex in 2021 to present pricing benchmarks to demonstrate that the proposed pricing is at market. And PSOD and ORM invested in various information technology (IT) systems to support their work.

ADB's key objectives for investment and credit risk management of NSO were largely achieved in the evaluation period. The AAA credit rating has been protected. Nonperforming loan indicators for lending transactions have been in line with those of comparable multilateral development banks (MDB). Actual credit losses on the nonsovereign loan portfolio have been relatively low and lower than initially modeled. The risk management organization and processes are similar to those of MDB peers, and the quality of risk reporting is high. However, areas for improvement include clarity on the risks ADB is willing to take, performance monitoring and management, processing efficiency, pricing guidelines, and updating of risk management tools and management information and IT systems.

Many Opportunities to Improve

[Confidential information deleted.] Specific operational guidance is not available on the risks incremental to those accepted by a commercial institution evaluating the same transaction. [Confidential information deleted]. But they have been agreed and implemented for only certain financial institutions programs. An investment framework for NSO is under consideration to guide PSOD strategy and clarify portfolio objectives.

ADB does not sufficiently utilize quantifiable key indicators across the organization to better assess and align NSO risk and investment performance. Since the introduction of Strategy 2030 in 2018, PSOD has focused on the number of transactions as its key financial performance indicator (instead of commitment volumes). Responsiveness is monitored by risk teams across MDBs, including ADB. MDB peers and commercial banks monitor several quantitative and qualitative indicators to assess performance, many of which ADB does not formally use as key performance indicators with targets. Additional quantitative metrics tracked by other institutions for operations teams include commitment volume, risk-adjusted return on capital (RAROC), and internal rate of return (for equity transactions). For risk teams, the metrics include responsiveness (turnaround time), end-to-end credit processing time, early identification of deteriorating credits, and portfolio credit quality indicators. ADB operations and risk teams do not have shared financial indicators to align performance incentives.

The processing times for ADB NSO projects have improved but are still longer than those of MDB peers. [Confidential information deleted]. Safeguard requirements, credit risk, legal requirements, and clients were noted as the main drivers of delays, according to PSOD and ORM staff surveys. Due to lack of data and appropriate tracking systems, there is no direct evidence to identify the leading processing bottleneck for delays. Furthermore, attribution analysis identifying the main drivers for processing delays was not possible because of the limited monitoring information available from the current NSO management information systems. Cancellations and the end-of-year bunching of transactions also strain the approval system and contribute to longer times.

While the agreement on market pricing between operations and risk teams has improved, clear guidance for NSO transaction pricing is not available in a comprehensive document. [Confidential information deleted]. Clarity on expected pricing for debt transactions is limited, especially when cost recovery pricing calculated by ADB is higher than market pricing. The transaction approval governance structure does not include guidelines to clarify NSO transaction pricing for transaction teams and risk approvers. [Confidential information deleted].

Despite some improvements, updating and mainstreaming ADB's risk management information and IT systems to improve information flows have been considerably delayed. Discussions on further initiatives have been underway for up to 10 years. ADB has not implemented a fully integrated end-to-end online risk management system to reduce duplication of data, improve information flows, and strengthen governance and accountability. Discussions on a risk and NSO data mart among PSOD, ORM, and the Information Technology Department have continued under the NSO Change Program over several years. NSO lack a one-stop shop with the responsibility to upgrade and use management information and IT systems to monitor and integrate portfolio metrics, supply the associated performance narrative to senior management and the Board, and incorporate the metrics in budgets and strategies.

Recommendations

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.** The risk guidance frameworks will provide cascaded operational guidance to drive more focused NSO execution.

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.** For operations teams, ADB can consider reintroducing the commitment volume indicator

and reporting on RAROC for debt and internal rate of return for equity. Disbursement volumes can be tracked. For the credit risk team, early identification of deteriorating credits and portfolio credit quality indicators incorporating credit cycle norms (nonperforming loan ratio, weighted average risk rating, or similar) can be considered as additional indicators. Selected performance metrics for the credit risk team can incorporate operations teams' targets—and vice versa—to align incentives, particularly for senior staff. Systems will need to be implemented to track and measure the additional key performance measures.

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.** Certain process improvements and delegation initiatives aligned with the recommendation have been included in the September 2023 revision to the Operations Manual's NSO section (D10) and will need to be built upon and operationalized. Key internal and external reasons for partial and full cancellations should be identified and used to inform transaction selection and approval at an early stage. ADB should avoid bunching and spread credit approvals across the year to help manage resources and maintain quality. This aligns with the new operating model to rationalize internal credit and noncredit processes and documentation requirements on a risk-based approach without diluting ADB's due diligence and underwriting standards.

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.** Clear and detailed guidelines on pricing may speed up decision-making and inform PSOD's portfolio approach to transaction pricing and return targets in line with the strategic priorities and available resources. Clarity can be provided on whether ADB can try to price transactions appropriately to attain desired return targets on a portfolio basis.

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.** ADB should implement the allocated administrative cost, expected loss, and capital cost assumptions underlying the cost recovery pricing model, and inform the calculation of RAROC. The model should be updated annually so ADB uses the most recent information for pricing decisions and is better positioned to make informed pricing decisions for clients.

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.** An integrated end-to-end online system will help unify data sources across ADB. It will increase efficiency by reducing data duplication, improving information flows, and strengthening governance and accountability. The IT system can track and measure expanded key performance indicators.