To: The Board of Executive Directors
From: The Secretary
Subject: Additional information regarding the investment policy review evaluation (document RE-347)

Inquiries to: Stephen A. Quick (extensión 1241) o Martin Naranjo (extensión 3666)

Reference: RE-347(12/08), RE-347-1(1/09)
IN ADDITIONAL INFORMATION REGARDING THE INVESTMENT POLICY REVIEW EVALUATION (DOCUMENT RE-347)

In comments during the consideration of the investment policy review by the Budget and Financial policies committee, Directors raised two issues that call for additional comment by OVE.

1. Risk Appetite Statement

The Director for Germany, Italy, Belgium, Israel, The Netherlands, and Switzerland asked the following question: “We would like to ask OVE’s opinion with respect to Management’s response regarding a Board approved explicit risk appetite statement. We would like to know if OVE thinks Management’s line of action would be sufficient and – if not – would like to ask OVE to provide an example regarding this recommendation.”

Management’s written comments on the OVE recommendation that the Board approve a specific appetite statement were as follows:

“Management agrees that the Board should approve an explicit risk appetite statement. The Bank needs to define a quantitative risk tolerance or “risk budget” or its liquidity portfolio, and is currently in the process of installing system capabilities for measuring aggregate portfolio risk, so that an appropriate limit can be evaluated and proposed as part of the capital adequacy policy. In addition, as part of the New Operational Framework (NOF), Management will be presenting to the Board at the end of 2009 a revised Capital Adequacy Framework, which will include the risks on investment portfolio assets”.

In this paragraph, Management’s statement treats a risk appetite statement as equivalent to a capital adequacy policy. While OVE agrees that an enhanced capital adequacy framework is required, and that liquidity should be regarded as an “asset at risk” against which capital should be allocated (in contrast to the present capital adequacy policy), this approach does not capture many of the dimensions of a comprehensive risk appetite statement.

“Risk tolerance” and “risk budget” both refer to a quantitative measures of an institution’s risk. It is a description, not a strategic guidance statement. In contrast, a risk appetite statement contains guidance from the Board as to how to manage the business and what types of risk should be taken on in pursuit of that strategic direction.

As part of the investment policy review, Oliver Wyman provided a sample “risk appetite statement” showing a number of dimensions that could be treated in such a statement. This sample is attached as annex 1.
2. **Factual errors**

One Director indicated that the report contained factual errors related to loan charges. As recorded in the minutes, the statement was:

a. *With respect to the “unacknowledged incentives” mentioned in 1.2 (d) above, and in para. 4.21 of the report, the implication that excessive risk had been taken in order to generate income and thereby reduce loan charges was factually wrong. At no point had the Board’s discussion on investment activity related to the possibility of reducing loan charges (Argentina).*

OVE does not believe the text contains any factual errors. The complete text of paragraph 4.21 states:

“Despite this clear policy guidance, when the ALM framework was approved, the Bank’s policy for setting loan charges was based on targeting a certain level of income, and in that environment, positive investment income from the liquid investment portfolio helped to reduce the charges required on loans to meet the net income target. While the sums involved were relatively small, any reduction in loan charges was seen in a positive light by many shareholders. This helped to create internal institutional incentives for improving the returns on the portfolio”

The paragraph does not claim that “excessive risk” had been taken. It simply notes that increasing investment income would have a positive effect on loan charges, given the policies that were in place when the ALM framework was approved (1997).

In fact, a basic goal of the ALM document (GP-120-2) was to reduce both the volatility and the overall level of loan charges. Paragraph 1.5 of GP-120-2 states: “The first goal of the Bank’s asset/liability management is to minimize the cost and volatility of financing its OC loan products while minimizing the financial risks, for the Bank and its clients, associated with such intermediation. The second goal is to minimize the volatility and the average level of the Bank’s OC loan charges.” The link between loan charges and investment income in 1997 was central to the ALM policy framework.

Net income targeting was abandoned by the Bank in 2003 with the adoption of a new capital adequacy policy which severed the direct link between loan charges and investment returns. However, the desire of some Board members to increase investment returns (and thus maintaining the institutional incentives to reach for yield), were documented in the panel report’s footnote 5, which noted that the minutes of the February 12, 2007 Budget and Financial Policies Committee meeting stated: “several Executive Directors suggested that the Bank assume more risk, to increase the return on its investments.”
## Annex 1

**Illustrative comprehensive risk appetite statement**

<table>
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<tr>
<th>Criteria</th>
<th>Statement</th>
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| 1. Target debt rating | - We will seek to maintain an enterprise-level debt rating of __
| | - At all times we will be investment grade |
| 2. Earnings at Risk capacity | - We will position ourselves in the top third of our peer group in terms of deviation from expected earnings |
| 3. Target capital ratios | - This means that we will not miss start of year consensus earnings forecasts by >__% more than 1 year in __ |
| 4. Self-sustaining growth | - On a regulatory basis, our target Tier 1 ratio is __%
| | - The ratio will not fall below __% more than 1 year in __ |
| | - On an economic basis, we will seek to maintain an AFR ratio of at least __%
| | - This will not fall below __% more than 1 year in __
| | - The buffer will not exceed __% except for explicit strategic requirements |
| 5. Target liquidity ratios | - New business will not dilute capital ratios and will enable maintaining of target liquidity ratios (see statement 5)
| | - Outside of specific strategic opportunities, we will not have to perform a rights issue more than 1 year in __ |
| 6. Management of concentrations | - We will seek to maintain an absolute funding ratio in line with the strategic plan and the median set of our peers (2005: __%, 2006: __%)
| | - This will not increase more than __% year-on-year |
| | - In normal and stressed operating conditions the Group liquidity policy will ensure that the Group has sufficient funds to meet claims arising from customer liability demands or asset commitments |
| | - In liquidity crises .....
| 7. Regulatory compliance | - We will maintain our aggregate risk profile over the next 12 months
| | - __% of earnings should come from our home market, with no more than __% coming from any other single geography
| | - Non-interest income will represent __% of earnings
| | - Credit risk
| | - No single asset class should represent >__% of exposure
| | - Exposure to a single customer/group of customers will not exceed the limits set out in the Group Large Exposures Policy
| | - Market risk
| | - The DVAR to shareholders equity ratio will be between __% and __%
| | - The investment portfolio to shareholders equity ratio will remain between __% and __%
| | - Aggregate risk profile
| | - Credit risk will make up __% of fully diversified aggregate risk profile
| | - .....
| 8. Operational risk | - We aim to exceed legal regulatory requirements in key geographies
| | - We seek to score in the top quartile of peer set in regulatory reviews
| | - We have zero tolerance for intentional regulatory breaches
| | - To support the statement, we will have a suitably resourced compliance manager in each Division
| | - __% of staff at any one time will have completed required compliance training |
| 9. Franchise risk | - We aim to achieve operational excellence and seek to maintain a ‘no surprises’ operational risk environment
| | - All events to be disclosed in line with escalation criteria and early warning signals .....
| 10. Strategic risk | - Annual operational losses will not exceed __% of revenues
| | - Losses from any single source will not exceed __%

*Source: Oliver Wyman*