Budget and Financial Policies Committee

For consideration
Subsequently Committee of the Whole, if so agreed

To: The Board of Executive Directors
From: The Secretary
Subject: Management response to OVE’s document “Review of the Bank’s Investment Policy”

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Reference: RE-347(12/08)
Management Response to OVE Review of the Bank’s Investment Policy
We read with great interest the OVE report, “Review of the Bank’s Investment Policy: Expert Panel Report” (RE-347). We welcome the input and validation to Management’s current endeavors of revising the Bank’s financial and risk management policy and governance framework that was started with organizational changes as part of the realignment and will be concluded with various recommendations for policy revisions to the Board of Executive Directors during 2009.

We will not engage in a point-by-point discussion of the facts, analysis, observations, and conclusions contained in the report, rebutting those we may have issue with. Rather, we will keep our response brief and focused on two areas:

1. A summary of what we think are the most important facts and observations about the current financial crisis and the performance of the Bank’s trading investment portfolio, the role of credit ratings, and the size of the portfolio. (See Section I)

2. Management’s view on each of the seven recommendations made by OVE, most of which we agree with, what we have done and propose to do in response. (See table below, and Section II)

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<th>Summary of OVE Recommendation</th>
<th>Management View</th>
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<td>Rec 1 Modify Liquidity Policy to define “core liquidity” needs, distinguishing between assets held for this purpose and those held as “war chest” against regional economic crisis</td>
<td>Agree</td>
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<td>Rec 2 Establish clear guidelines for core liquidity portfolio, accepting “cost of carry” if needed to ensure liquidity under most adverse market conditions</td>
<td>Agree</td>
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<td>Rec 3 Consider reducing or eliminating war chest portfolio, relying more on shareholder support to retain AAA</td>
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<td>Rec 4 Approve an explicit risk appetite statement</td>
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<td>Rec 5 (a) Consider which portion of the portfolio should be managed internally vs externally</td>
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<td>(b) Manage only the most simple portfolios internally</td>
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<td>Rec 6 Strengthen Risk Management function</td>
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<td>Rec 7 (a) Establish Board Investment Policy Review Committee</td>
<td>No view</td>
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<td>(b) Hire permanent panel of external experts to advise Board on investment portfolio issues</td>
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Section I. Key Facts and Observations

1. The financial market crisis that began in July 2007 is without precedent. And while there were warning signs that seem clear when looking back, as there always are, this crisis was not anticipated by the market, regulators, or analysts. The fact that it was not anticipated, of course, is one reason why it has turned out to be so nasty.

   a. The crisis began with concerns on the value of MBS backed by U.S. subprime mortgages in the wake of declining real estate values, spreading to the broad ABS/MBS universe as structured investment vehicles (SIVs) were forced to sell stronger assets when they were unable to refinance themselves in the asset-backed commercial paper (ABCP) market.

   b. Losses from collapsing ABS/MBS prices brought down hedge funds, and forced massive write downs at banks and financial institutions globally, including AAA mono-line insurance companies which insured many structured assets.

   c. With nearly weekly government interventions in long-established financial institutions in September 2008, and the bankruptcy of Lehman Brothers on September 15, fear gripped the financial markets causing investors to seek safety at any cost. This caused credit markets to freeze, and drove U.S. Treasury Bills yields to zero and below for the first time in history.

   d. Even investors who had anticipated some of the initial problems in the overvalued real estate markets could not anticipate how the problems in one sector would cause problems in another.

   e. Still, those such as the IDB with large exposures to ABS/MBS, even the safest AAA tranches, have suffered the largest mark-to-market declines.

   f. But it is worth noting, as quoted in the report: “The pattern of IDB performance is not worse than that of the market” (p.13) and Management was “in full conformity with the Bank’s policies and guidelines” (p.1).

   g. It is also worth noting that prior to July 2007, the ABS/MBS assets held by the Bank were very stable in terms of price performance and could be sold at prices close to par.

2. While the Bank has recognized on its financial accounting statements significant losses related to its trading investment portfolio, almost all the booked losses are unrealized and against ABS/MBS bonds that are still performing and investment-grade rated (indeed, still mostly AAA 18 months after the crisis began). To put this in perspective, we note the following (all figures are as of 31 December 2008 or for the 18-month period ending then, unless indicated otherwise):

   a. Of $1.9 billion in valuation losses booked, $1.3 billion (68% of total losses) are on ABS/MBS assets still rated AAA. And 87% of total losses ($1.6 billion of the $1.9 billion booked), are accounted for by market price declines on performing assets rated A- or better.
b. Not only are these assets paying interest, but the Bank received $750 million in principal prepayments on the ABS/MBS portfolio in 2008.

c. Only $79 million in losses (4% of the total) have been realized, either because the asset was restructured or because it was sold prior to maturity at a discount. An additional $33 million face of ABCP is in default, awaiting restructuring.

d. Offsetting these losses are the gains realized from the Bank’s investment strategy implemented in 1998. Cumulative interest earned over the cost of borrowing from January 1998 through December 2008 was $321 million. And compared to the lowest risk strategy of holding only T-bills, the cumulative contribution to income has been $607 million (though arguably a T-bill only strategy might have been smaller reducing this difference somewhat).

3. When considering the recent performance of the Bank’s trading investment portfolio, it is important to understand what credit ratings mean and how they have been used.

a. Credit ratings grade the likelihood, in the view of the rating agency (S&P, Moody’s, or Fitch), that a bond will pay principal and interest on time as contracted. Credit ratings do not grade the likelihood that a bond may be sold in the market prior to maturity without loss.

b. By policy, all ABS/MBS bonds owned by the Bank were AAA at the time of purchase. In addition, any ABS/MBS bonds purchased were subject to additional credit analysis screening by the FIN/TRY investments team.

c. The AAA rating should mean that the risk of payment default is very low (though not zero). While 17% of the Bank’s ABS/MBS portfolio (by notional value) is now rated less than AAA, none have yet defaulted in payment (though 4% are now rated below investment grade).

d. The additional analysis by the Bank’s investments team should mean that the ratings and payment performance on the Bank’s ABS/MBS assets should be better than that of the broader universe. And to date, that has been the case, as was acknowledged by OVE in their report. While Oliver Wyman (OW) did not perform an independent assessment of the underlying credit quality of the ABS/MBS assets held by the Bank, they did note that the ratings and payment performance was better than that of a broad S&P universe.

e. The only actual defaults to date in the Bank’s trading investment portfolio were in the ABCP holdings. When the crisis began, the Bank held $1.0 billion in short-term ABCP across portfolios, all rated A1+, the highest short-term rating as required by policy, issued mostly by SIVs and similar conduits. When the run on the SIVs occurred in the third quarter of 2007, the Bank was able to get paid out on all but $99 million.

4. Notwithstanding the observations above, we agree with the OVE assessment that the current financial crisis has exposed flaws in the Bank’s investment portfolio
strategy. The challenge going forward, however, is to learn the right lessons and take appropriate actions that correct those flaws without exposing the Bank to unnecessary risks or realized losses.

a. The main problem is not the large mark-to-market losses, which as we’ve noted are still concentrated in relatively strong assets. Realized losses are fairly small, and cumulative losses from payment default may ultimately turn out to be modest, less even than gains from the strategy over many years.

b. In our view, the main problem is that a significant portion of the Bank’s trading investment portfolio, which should be a source of liquidity in time of need, is illiquid, and could only be sold by realizing significant losses.

c. And while the overall size of the trading investment portfolio (targeted at 20-40% of OLB by the Bank’s Liquidity Policy) may well be larger than is needed for purposes of backstop liquidity, we are fortunate that it is so large. While half the portfolio is illiquid, the other half is liquid. And the liquid half is sufficiently large itself to provide an ample cushion for the Bank to meet all its obligations even if there were some interruption in its access to the capital markets, and without forcing a costly fire sale of the illiquid half.

Section II. Reaction to specific OVE Recommendations

Management has taken or is considering a number of actions, which are highlighted below in the discussion of each of the seven recommendations made by OVE in their report. These actions are being taken not only in reaction to the financial crisis, but because they are good risk-management practices generally to be followed even in calmer times.

1. Management fully agrees with the recommendation to modify the Bank’s Liquidity Policy to define “core liquidity” needs, distinguishing between assets held for this purpose and those held as a “war chest” against regional economic crisis. Informally, we have implemented this distinction by separating assets that represent core liquidity (mostly T-bills, short-term agency paper, and bank deposits) from the illiquid assets (mostly ABS/MBS and longer-term bank floating rate notes). We are in the process of formally separating the portfolio reporting along these lines so that we may separately analyze and benchmark performance. We are also carefully monitoring the size of core liquidity to ensure that levels are adequate to meet near-term expected disbursements and debt repayments. In addition, we will review over the course of 2009:

a. Liquidity Policy (by 2Q of 2009)

b. Asset-Liability Management (ALM) Policy (by 4Q of 2009)

c. Whether changes can be made to the policies governing the HTM portfolio to make those assets more readily available as a source of liquidity, if needed (by 1Q of 2009)
2. Management also agrees with the recommendation that clear guidelines should be established defining the liquidity characteristics of permitted investments for a core liquidity portfolio. We should consider whether these guidelines should allow some flexibility to adapt to conditions at the time. No two financial crises are the same, and assets that may seem very safe in the current crisis may warrant more caution in a future one, and vice-versa. Informal guidelines are in place for the current crisis, reflecting our best judgment on which assets are safe. We also note that liquidity can be offered even on assets that can’t easily be sold if they mature prior to the need for funds (e.g. ahead of large debt repayments or likely loan disbursements). Management has been working on its own review of the “Investment Strategy and Authority” which also detected and addresses some of these issues and which, after approval, would be followed by revised Investment Guidelines. This review (to be presented to the Board in the first quarter) also takes into consideration how risk and control policies and practices have evolved in the market place, including those at other MDBs.

3. Management advises caution on the recommendation to consider reduction in the size of the “war chest” portion of the portfolio. We agree that its size should be carefully considered, and that it may well be smaller than the current size of the illiquid portion of the current trading investment portfolio. But we don’t think the Bank’s “historical track record and strong support from shareholders” are a substitute that would necessarily “allow multilateral banks to retain AAA credit ratings without reliance on liquidity ‘war chests’”.

4. Management agrees that the Board should approve an explicit risk appetite statement. The Bank needs to define a quantitative risk tolerance or “risk budget” for 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.

5. Management also agrees that a portfolio conforming to this risk appetite may be managed either internally by bank staff or externally, or both. The Bank should manage internally only those sub-portfolios for which it has proper systems and expertise, and it should outsource sub-portfolios which require specialize expertise we don’t have, but which nonetheless offer exposure to assets we think add value. In fact the Bank currently has an externally managed portfolio program (EMP). Funds allocated to the EMP are for a convexity-based strategy which diversifies and complements the Bank’s own strategies. But part of this consideration should be cost. While it doesn’t flow through the administrative budget, outside management is very expensive.

6. We agree with the goal of strengthening the Risk Management function. That is a high priority as evidenced by the formal creation of a Risk Management Group (RMG), the ongoing reviews to address possible adjustments to its Risk policies and the procurement of necessary resources to achieve the above. In support of this goal, we note the following:
a. The Credit Risk function is rolling out the Credit Risk Classification System in NSG/OMJ operations aiming to improve the quality of our ratings as evidence of risk assessment of our Projects.

b. The recently-approved Integrated Capital Adequacy and Portfolio Analytics project is already under accelerated implementation and will be the cornerstone of our capability to address the market risks which are managed in our Treasury (including the Investment Portfolio) and Strategic Risks areas, and support the ALM function.

c. Potential new Risk Officers are presently being interviewed to fill positions which will solidify our current efforts, but also to manage new functions being expanded to address the increased complexity associated with risks convergence.

d. The Risk function currently reports to the EVP/Presidency Office. It has weekly interaction with EVP to discuss Risk matters, sits on the Senior Management, Operations Policy, Finance, Procurement and Watch List Committees, and it is the Chair in the ALCO and Non-Accrual Committees. Furthermore, the RMG function has recently secured approval of all critical resources needed for the 2009 budget cycle. Management believes it is not necessary to change the current organizational set up, but suggests that in order to better reflect the increased relevance of the function, it is appropriate to rename the title for the head of RMG from Advisor to Chief Risk Officer.

7. Management advises caution on how the recommendation to improve Board oversight is implemented. How the Board organizes its work among Committees and which Committee should review investment policy is, of course, the Board’s decision. Management believes it is not advisable to dilute its responsibility and accountability by creating a parallel entity involved in the details of investment management. Recently, Management responded to the Board’s request to improve the quality and timeliness of the information reported to the Board on Investment Portfolio performance and risks. The new report has been implemented and is being provided to the Audit Committee, which Management believes is the sufficient and adequate vehicle for Board oversight. In terms of Management’s own oversight, we have instituted 830am daily market review meetings at the office of the CFO to review market events and Bank exposures. These meetings are attended by the head of RMG and TRY and their senior staff, including the head of Investments.