To: The Board of Executive Directors

From: The Secretary

Subject: Management’s concluding comments on document: “Review of the Bank’s Investment Policy” (document RE-347)

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Management Concluding Commentary on RE-347

At the Budget and Financial Policies Committee (BUFIPOL) meeting on 16 March 2009, Management made oral comments regarding the OVE report, “Review of the Bank’s Investment Policy: Expert Panel Report” (RE-347), expanding on those made orally in previous meetings and in writing. At the request of the Committee, Management is providing here some additional remarks to conclude its commentary on the findings and recommendations of the Expert Panel Report.

In Management’s Response to the Expert Panel Report (RE-347-1), dated 16 January 2009, we addressed two topics:

- **Section I**: Our summary thoughts on the current financial crisis and on the performance of the Bank’s trading investment portfolio, the role of credit ratings, and the size of the portfolio.
- **Section II**: Our view on each of the seven recommendations made by the Expert Panel, most of which we agreed with, what we had done and proposed to do in response.

Regarding the specific Expert Panel recommendations, the table below (also included in RE-347-1), summarizes Management’s view on each:

<table>
<thead>
<tr>
<th>Rec</th>
<th>Summary of OVE Recommendation</th>
<th>Management View</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>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>
</tr>
<tr>
<td>2</td>
<td>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>
</tr>
<tr>
<td>3</td>
<td>Consider reducing or eliminating war chest portfolio, relying more on shareholder support to retain AAA</td>
<td>Advise Caution</td>
</tr>
<tr>
<td>4</td>
<td>Approve an explicit risk appetite statement</td>
<td>Agree</td>
</tr>
<tr>
<td>5</td>
<td>(a) Consider which portion of the portfolio should be managed internally vs externally</td>
<td>Agree</td>
</tr>
<tr>
<td></td>
<td>(b) Manage only the most simple portfolios internally</td>
<td>Advise Caution</td>
</tr>
<tr>
<td>6</td>
<td>Strengthen Risk Management function</td>
<td>Agree</td>
</tr>
<tr>
<td>7</td>
<td>(a) Establish Board Investment Policy Review Committee</td>
<td>No view</td>
</tr>
<tr>
<td></td>
<td>(b) Hire permanent panel of external experts to advise Board on investment portfolio issues</td>
<td>Advise Caution</td>
</tr>
</tbody>
</table>
In the Appendix, we include a table summarizing the specific actions and a timeline for implementing policies and procedures that will address those recommendations Management agrees with (1, 2, 4, 5(a), and 6).

Management view of the Expert Panel’s Report

In RE-347-1, Management declined to engage in a point-by-point discussion of certain sections of the Expert Panel’s Report dealing with historical facts, analyses, observations, and conclusions offered in support of the Panel’s recommendations. While we did find such sections to be somewhat unbalanced, since we agreed with a majority of the Report’s recommendations, we thought it more constructive to focus on the future and what steps needed to be taken going forward.

Since there has been some attention outside the Bank focused on one particular finding by the Expert Panel (in paragraph 6.5) related to a Report by the Bank’s Office of the Auditor General (AUG), we would like to take this opportunity to offer some additional information about that issue.

The Expert Panel here was referring here to a report from AUG to the Manager of the Finance Department (FIN) dated 11 January 2006 with the subject of “Investments – Front Office Limited Review” (the “AUG Report”). The objective of the review was “to test the controls related to selected processes carried out in the Trading Room of the Bank’s Investments Section.” The “Results” of the review were the following: “Based on the results of our review, nothing came to our attention to indicate that the internal controls were not in place and operating effectively during the period reviewed.”

The AUG Report included Grade III recommendations concerning the control, analysis and monitoring of investments, including ABS and MBS. In 2006, AUG recommendations were classified in one of four grades (“I” through “IV”), with Grade I recommendations being considered critical and the other classifications representing decreasing relative levels of importance. At the time of the AUG Report, the Bank had established limits for concentrations in ABS and MBS, and the Bank’s holdings were within those limits.

Regarding the reporting of recommendations to the Audit Committee, AUG periodically reports, for each audit, the number of recommendations, their grade, and the details of Grade I recommendations. AUG discusses with the Committee only Grade I recommendations, unless Committee members raise specific questions.

In the ordinary course of business, AUG and the Finance Department (FIN) review the status of Management’s response to AUG’s recommendations. Management is in the process of addressing this AUG recommendation. FIN and the Risk Management Unit (RMG) are working jointly to resolve this issue by establishing formal issuer limits for ABS and MBS, set and monitored through the same mechanisms that are used for banks and corporates.
## Appendix – Summary Actions and Expected Timeline

<table>
<thead>
<tr>
<th>Item</th>
<th>Start Time</th>
<th>Expected Delivery</th>
<th>Item Description</th>
<th>Completed</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>2008</td>
<td>Q1 2009</td>
<td>Informal modification of portfolio by separating into “core liquidity” and “war chest” portions</td>
<td>✓</td>
</tr>
</tbody>
</table>
| 2    | 2008       | Q2 2009           | Review of the Bank’s Investment Strategy  
- Provide analytical basis for coming policy changes  
- Identify Gaps and Benchmark vs MDBs  
- Present to Finance Committee  
- Present to Board for information | ✓ ✓ ✓ ✓ |
| 3    | Q1 2009    | Q2 2009           | Revise Liquidity Policy  
- Formalize separation of portfolio into “core liquidity” and “war chest” portions  
- Define size (needs for “core liquidity” and “war chest” portions, respectively)  
- Establish clear definition of ‘liquidity’ characteristics for permitted investments for “core liquidity” portion  
- Consider what changes can be made to MOV/HTM  
- Present to Finance Committee  
- Present to Board | ✓ ✓ ✓ ✓ |
| 4    | Q1 2009    | Q4 2009           | Implementation of the Integrated Capital Adequacy and Portfolio Analytics System (ICAPA) | ✓         |
| 5    | Q2 2009    | Q2 2009           | Revise Authorization to Invest Bank Funds  
- Review the universe of eligible instruments for the Liquidity Portfolio  
- Present to Finance Committee  
- Present to Board | ✓ ✓ ✓ ✓ |
| 6    | Q2 2009    | Q2 2009           | Revise Liquid Assets Investment Guidelines  
- Adapt Guidelines to findings and recommendations of the Investment Strategy review and the Investment Authority review  
- Present to ALCO | ✓ ✓ ✓ ✓ |
| 7    | Q3 2009    | Q3 2009           | Portfolio Analytics enhancements  
- Develop system capabilities for proper measurements of aggregate portfolio risks  
- Test preliminary metrics  
- Stage one: VaR | ✓ ✓ ✓ ✓ |
| 8    | Q3 2009    | Q4 2009           | Revise Capital Adequacy Framework  
- Develop revised Capital Adequacy Policy document  
- Finalize development of new Capital Adequacy Model  
- Define a quantitative “risk budget”  
- Present to Finance Committee  
- Present to Board | ✓ ✓ ✓ ✓ |
| 9    | Q3 2009    | Q3 2009           | Revise Asset Liability Management Policy  
- Present to Finance Committee  
- Present to Board | ✓ ✓ ✓ ✓ |
| 10   | Q4 2009    | Q4 2009           | Portfolio Analytics enhancements (cont’d)  
- Develop system capabilities for proper measurements of aggregate portfolio risks  
- Implement & test preliminary metrics  
- Stage Two: Scenario Analysis and Stress Testing | ✓ ✓ ✓ ✓ |
| 11   | Q4 2009    | 2010              | Revise the externally managed portfolio program  
- Ensure conformity to proposed Risk Appetite Statement  
- Clear distinction between which sub-portfolios should managed internally versus externally  
- Present to ALCO | ✓ ✓ ✓ ✓ |
1. Separation of Investment Portfolios by Purpose
2. Review of Investment Strategy
3. Revision of Liquidity Policy
4. Implementation of Integrated Capital Adequacy and Portfolio Analytics System
5. Revision of Investment Authority
6. Revision of Investment Guidelines
7. Enhancement of Portfolio Analytics (Part 1)
8. Revision of Capital Adequacy Policy
9. Revision of Asset/Liability Management Policy
10. Enhancement of Portfolio Analytics (Part 2)
11. Revise External Managers Program