To: The Board of Executive Directors
From: The Secretary
Subject: Management’s further comments/response to OVE’s document: “Review of the Bank’s Investment Policy”. Revised version as of 20 March 2009

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Remarks: This revised version of document RE-347-3, replacing the original version, is being distributed as agreed at the 20 March 2009 meeting of the Board of Executive Directors, where its release to the public was authorized in accordance with the Bank’s disclosure of information policy.

Management’s further comments/response to OVE Review of the Bank’s Investment Policy following Bufipol meeting on January 22, 2009

During the Bufipol meeting on January 22, 2009 additional questions were asked and comments made. Management addresses these below.

1. **In response to the crisis, what criteria has Management set for selecting its staff in the Finance Department (FIN) and the Risk Management Group (RMG) - e.g., has management made a CFA a requirement?**

The realignment allowed Management to put in place a modern risk organization and, consequently, a new team to manage FIN and RMG. A merit-based selection process was used for both external and internal hires. As a result, Management hired several senior officers from outside the Bank, notably the FIN Manager and CFO (joined in February 2008); the Advisor, RMG (April 2008), and the Treasurer (December 2007).

Inside FIN/TRY a reorganization took place, allowing for two internal promotions, a new Head of Funding (May 2008) and a new Head of Investments (July 2008).

FIN/TRY and RMG are comprised of highly-skilled, seasoned, and internationally rounded professionals, many of whom have earned accolades and honors for both studies as well as professional achievements. The educational levels present are well-diversified, including MBA, CFA, Ph.D., and MA.

2. **In Management’s response it sets out a timetable for Board review of various policies. We are pleased to see that we should be receiving papers on investment guidelines in the first quarter. But why do we need to wait for the 2nd quarter for a review of the liquidity policy? We should have a comprehensive and coordinated review of relevant policies as soon as possible. We also request that management put together an action plan for responding to the concerns addressed in the report and the concerns addressed in this meeting**

First, we would like to correct the misunderstanding (of point II.2. in document RE-347-1) that Management is presenting a review of the Liquid Assets Investment Guidelines for Board approval. Such guidelines, falling under prevailing and Board-approved authorizations and policies, are approved by the Bank's ALCO, not the Board. What we intend to present in Q1 09 is Management's own review of the "Investments Strategy and Authority".

Management would like to emphasize that we are very focused on the policy review, cf. also #6 below, and we expect to present our suggestions to the Board in accordance with the time table laid out in II.1. in document RE-347-1. This effort will entail, inter-alia, in-depth scenario- and sensitivity-analyses, stress-testing, benchmarking, conversations and comparisons with other MDB’s policies and experience, as well as internal discussions across many departments and sections. All this while at the same time also engaged in many strategic efforts for the Bank,
including NOF discussions, possible capital replenishments of OC and FSO, etc. as well as having to fully operate in unprecedented and historically difficult market conditions.

3. Management and OVE both claim “that the pattern of IDB performance is not worse than that of the market.” This is an unusual statement to be made by a management of a development bank. Development banks are not expected to take substantial risks outside of those related to projects in developing countries. Moreover, the IDB should be compared to the other MDBs and an evaluation taking other MDB best practices into account is appropriate.

The Bank manages its liquidity in accordance with prevailing authorities and policies - as approved by the Board. As also stated in the OVE report, Management has not violated any such authorities and policies.

All liquidity management has an element of risk, and current policy concentrated on one source of risk, credit, rather than liquidity. While in retrospect it is clear that the Bank’s diversified ABS/MBS portfolio was vulnerable to the exact systemic crisis which we are now in, there was no historical precedent for this.

We agree that the Bank should not take substantial risks outside those related to its core mission. But investment decisions and risk must be judged based on information available at the time. At the time decisions were made, high quality AAA ABS/MBS could be sold with minimal liquidity concession, and the historical price volatility for these instruments was extremely low. And while recent experience suggests that some of the AAA ratings awarded to structured assets may not be so sound, prior to this crisis AAA was considered very solid. Even now, all the original AAA ABS/MBS assets are performing, more than 80% are still AAA, and more than $1 billion of the nearly $7 billion ABS/MBS portfolio held on July 31, 2007 has been prepaid at par.

And, for the types of Board-approved risks we were and are now exposed to, the Bank’s portfolio has performed in line with other MDBs.

During the Board discussions, several remarks were made about the relative size of the Bank’s liquidity portfolio compared with other MDBs. In the below figure, such comparison shows that the Bank holds relatively more liquidity as a % of total assets than World Bank (IBRD) and EIB, yet relatively less than AfDB, EBRD, IFC, and ADB.
4. It would be very useful if Management could provide a brief explanation of its divergence of holdings and concentration of ABS/MBS compared to the other MDBs referenced in the OVE report, including the IIC.

OVE’s report comparing the Bank’s holdings of structured finance with other MDBs is flawed. As of 2007, our holdings were 42%, and not above 60% as stated by OVE. Compared with IFC’s holdings of 37%, the divergence - to IFC - was relatively minimal.

Regarding IIC, in our understanding, the relative size of the portfolio renders it ineligible for comparison with the Bank’s holdings.
5. Although we still look at book losses in our investment portfolio, in 18 months they have grown to a level that significantly impacts the Bank’s reserves and TELR and therewith harms its lending capacity.

Management, recognizing that the unrealized losses have impacted its risk-bearing capacity, as measured by the TELR, as well as its lending capacity, would like, however, to emphasize that, at the end of 2008, despite the decrease, the TELR has held within the rate of 32% to 38% and that the unrealized losses so far have not limited our ability to lend to our borrowers as the lending capacity utilization was at 81.3% compared with 73.3% at the end of 2007.

6. We understand that Management has accepted most of the recommendations and would appreciate it if Management can provide us with a timetable for the implementation of OVE’s recommendations.

In document RE-347-1 management laid out its expected timeline for review of various policies, etc., i.e.:

- Liquidity Policy (by 2Q of 2009)
- Asset-Liability Management (ALM) Policy (by 4Q of 2009)
- HTM review (by 1Q of 2009)
- Review of "Investment Strategy and Authority" (by 1Q of 2009)