To: The Board of Executive Directors
From: The Secretary

Inquiries to: Director José Carlos Rocha Miranda (extension 1002)

Reference: RE-347(12/08)
The Budget and Financial Policies Committee (BUFIPOL) met on 16 March 2009 to wrap up discussion of the “Review of the Bank’s Investment Policy: Expert Panel Report” (document RE-347) and submit the report’s recommendations to the Board of Executive Directors for formal consideration.

The meeting was part of the Executive Directors’ ongoing discussion of the Bank’s investment policy, the advisability of which, possibly involving external specialists in a broader evaluation process, had become clear in late 2007. In early 2008 the President of the Bank proposed to provide an explanation of the Bank’s investment portfolio results to the Governors at the Forty-ninth Annual Meeting of the Board of Governors in Miami, held in March 2008. After the meeting, the proposal to proceed with an external review took shape. Accordingly, terms of reference submitted by the Office of Evaluation and Oversight (OVE) to engage the panel of external experts were approved at a BUFIPOL/PEC joint meeting on 19 June 2008, along with the budget supplement necessary for OVE to commission and supervise the studies. Also presented for formal consideration at the joint meeting were the outcomes of the discussions and meetings on the matter up to that point by the Executive Directors.

The external review was completed in late 2008 and, once released, was discussed initially at an informal meeting of BUFIPOL on 22 January 2009. The recommendations with which the Executive Directors and Management agreed were then incorporated into Management’s action plan, while it was also revising the Bank’s investment portfolio management practices. Issues raised by Executive Directors were followed by clarifications and additional comments from Management, and additional clarifications by OVE. Thus, when document RE-347 was formally considered at the BUFIPOL meeting of 16 March 2009, the Executive Directors registered approval of recommendations 1, 2, 4, 5a, and 6 of the panel of external experts (as cited in Management’s response, document RE-347-1), and Management reported on how work to implement them was proceeding.

Recommendation 1 – Modify the Bank’s Liquidity Policy by clearly distinguishing the actual liquidity needs... from the “war chest” function provided by holding assets:

- Management stated that the proposed new policy, explaining the distinction between “core liquidity” and “war chest,” will be sent to BUFIPOL in Q2 2009. This issue was addressed by Recommendation 3, which is still being discussed by the committee.

- Management stated that it would also submit a document in Q4 2009 on asset-liability management, containing what could be considered an ideal investment strategy, as a guide to inform and anticipate the new liquidity policy.
A third document, containing the types of risks that Management should consider for diversification of the Bank’s investments, should also be presented in conjunction with the capital adequacy framework. Briefly, this document should include proposals for risk diversification and management, portfolio management, and capital adequacy.

Recommendation 2 – Guidelines for the portion of the portfolio needed for liquidity purposes:

A document that defines “investment authority” will be sent to BUFIPOL in Q2. It will discuss what instruments the Bank will use to determine the level of liquidity for discretionary purposes.

Recommendation 4 – Approval of an explicit risk appetite statement:

Once the guidelines are approved for risk diversification and management, portfolio management, and capital adequacy, it will be possible to determine the Bank’s risk appetite. The relevant document is slated for submission to the committee in Q4 2009.

Recommendation 5a – Internal vs. external portfolio management:

The committee agrees with the proposal that a portion of the portfolio should be managed externally, as already reflected in the Bank’s investment management strategy. The panel’s suggestion, based primarily on the complexity of the instruments, does not address other aspects that the committee deems necessary for the final determination.

Recommendation 6 – Strengthen the Bank’s risk management function:

This recommendation, which requires a detailed definition of the Bank’s investment strategy, is related to determining the “basis across the risk spectrum involved in the Bank’s portfolio management.” Such a strategy entails: definition of the risk allocation that optimizes the mix of portfolio return and risk; enhancement of the decision-making tools for rating the risk of short- and long-term financial instruments, either with or without sovereign guarantee; and development of a framework to address the Bank’s operational risk.

Thus, approval of the new capital adequacy framework, slated for Q4 2009, is a precondition for completion of this process of strengthening the Bank’s risk management function.

The committee members have also asked Management to present a summary table with the current degree of implementation of these recommendations, pending studies and measures, and the exact deadlines for each.

Recommendations 5b (criteria for internal/external portfolio management), 7a (establish an Investment Policy Review Committee of the Board), and 7b (commission a permanent panel of external experts to advise the Board on investment portfolio issues) were not approved, because the information necessary for a conclusive discussion was not yet available. In the view of the Executive Directors, the matter should be placed on the agenda as soon as Management provides the necessary resources to do so.
Regarding specific aspects of documents RE-347, RE-347-2, and RE-347-3, it was the sense of the BUFIPOL meeting of 16 March 2009 that the considerations expressed in the document presented by the chair for Argentina and Haiti, attached hereto as annex, should be accepted.

The committee believed that the policy governing disclosure of Bank documents should be revisited as soon as possible by the PEC. The matter of the version of document RE-347 being posted on an NGO’s website should be discussed in the Audit Committee, as and when the Executive Directors see fit.

Lastly, Management clarified that the impact of unrealized losses on the Bank’s operational capacity was reflected, in accounting terms, in the Bank’s reserves, and had a one-to-one ratio to lending authority.

As Chair of the Budget and Financial Policies Committee, I recommend that the Board approve the considerations presented in this report.
1. The issue in discussion is a possible interpretation of statements contained in RE-347 (Expert Panel Report), RE-347-2 (responses from OVE to comments from Chairs), and RE-347-3 (Management’s response) as to whether the Board encouraged additional risk taking in the liquidity investments to generate additional income in order to reduce loan charges.

2. In document RE-347 paragraph 4.21 OVE states the following

4.21 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 footnote reads

5 For example, after Management’s presentation of the investment program in 2006, a few months before the crisis began, “several Executive Directors suggested that the Bank assume more risk, to increase the return on its investments”, as it is stated in the February 12th 2007 minutes of the Budget and Financial Policies Committee Minutes.

3. During the discussion of OVE’s report both the Chairs of Chile and Ecuador, and our Chair noted that there were factual problems with the construction of the paragraph and the footnote. Basically, the footnote takes as an example (note the “for example” in the footnote) to support the argument that there were incentives to increase income and reduce loan charges, a statement in minutes from a BUFIPOL meeting that took place in February 2007, when the policy commented in paragraph 4.21 had ended in 2003 with the adoption of a New Capital Adequacy Policy. In the following paragraph (4.22) notes, correctly, that the “specific link between loan charges and investment returns was severed in 2003 with the adoption of a New Capital Adequacy Policy,” and the paragraph continues with an argument that, in the opinion of the Expert Panel, there was still interest in “beating the benchmark and generating a negative cost of carry” but it does not link this to reducing loan charges. Therefore, our Chair and the Chair from Chile and Ecuador tried to highlight the fact that the example was factually inadequate for the point made in paragraph 4.21.

4. As a historical note it is also interesting to note that the ICR was way over the target since 2000, so in fact the policy established maximum waiver or minimum charges in an effort to keep the ICR back in track (i.e. lower incomes). This meant at that time a lending spread of 10 bp and full waivers for the credit fee and inspection and supervision fee. In other words, the income indicator to set loan charges was so high, that already
loan charges were as low as they could be (i.e. there were no incentives to keep on increasing incomes). Following this policy, Management recommended 10bp of credit spread and full waivers on the other two fees during the year 2002. Nevertheless, during the first semester of 2003, given some concerns about the quality of the sovereign portfolio, Management recommended and the Board agreed to pay more (50bp for lending spread, 50 bp for credit fee and 50bp for inspection and supervision fee ) (FN-573-2). Close to the end of 2003, the ICR was abandoned, so the potential incentive of some shareholders to increase the profitability of the investment portfolio in order to reduce loan charges disappeared.

5. In Document RE-347-2 OVE answers the comments as reflected in the draft minutes, which identify only our Chair as making the point. OVE does not address the point made above. The answer only reiterates that under the ALM and with the policy on loan charges before 2003, there was a link (although as noted in paragraph 4.21 the sums were “relatively small,” which leads to ask what is then their importance as incentives; see also the previous paragraph). Then OVE’s answer cites the footnote, but omits the crucial words “For instance” which is the issue raised by our Chairs: you cannot use as an example of intent of the Board pre 2003 a statement that happened in 2007. So we maintain our position that the construction of paragraph 4.21 and the footnote 5 is a factual mistake in the report.

6. In RE-347-3 Management uses the same reference to the minutes and says (point 3 page 4 under the Graph)

“Finally, we would like to note that, in February 2007 - during a Bufipol meeting, as recorded in the minutes - several Executive Directors suggested that the Bank assume more risk to increase the return on its investments. No dissenting views were noted.”

7. This is also an inaccurate reading of the minute. The full transcription in English of the relevant section is the following

“Higher investment return. Several Executive Directors suggested that the Bank assume more risk, to increase the return on its investments. Management reported that like other organizations, such as the International Monetary Fund and the World Bank, the Inter-American Development Bank was studying alternative ways of administering liquid assets to increase returns, with constant consideration given to the importance of maintaining its AAA rating.

The original in Spanish was

Mayor rentabilidad. Algunos Directores sugirieron la necesidad de asumir más riesgos con objeto de mejorar la rentabilidad del Banco. La Administración indicó que otros organismos, tales como el FMI y el Banco Mundial, están estudiando formas alternativas de administrar la liquidez para aumentar su rentabilidad. Señaló que también se están estudiando alternativas en el Banco, siempre teniendo en cuenta la importancia de mantener su calificación AAA.
8. Several points need to be mentioned. First, the original minute in Spanish talked about “algunos” or “some” in English, but the translation in English says “several” (which would have been “varios” in Spanish, and not “algunos”). Second, there was a response from the Administration to those “some” Directors, that clearly indicates that although Management may have been looking at alternatives to increase returns, it had to be done prudently (“with constant consideration given to the importance of maintaining its AAA rating”). Third, the minute closes this point with the call to prudence by Management, and the section on Actions and Recommendations (which is the one in which the Committee may have instructed Management) does not say anything about studying alternatives for greater returns. The implication is that the issue was settled with the answer given by Management. Four, and this does not come from the minute but from the recorded session, which we reviewed, a) the issue was raised by one Chair as a question in the context of the income problems that the IMF and the World Bank were having (because of the reduction in loans) and b) the rationale given for analyzing what these other institutions were doing was completely unrelated to loan charges but to the possibility of financing “other type of initiatives;” c) Management answered with a call to prudence that in the recording version is even stronger than what may transpire from the minutes; and d) two Chairs specifically echoed the call to prudence by Management. These comments were not reflected in the minute probably because, for the descriptive purpose of the minute in the section where the paragraph appears, the issue was considered already settled by the answer of Management.

9. The recommendation of this Chair is that Management omits the phrase referred in paragraph 5 of this document, and that OVE eliminates the footnote, or places properly, with a full transcription of what was discussed and a proper interpretation of what minutes mean.