6 Policies for Portfolio Quality and Management

Introduction: Why Country Exposure Risk matters

The last chapter dealt with the building up of provisions and reserves to ensure the financial viability and sustainability of the MDBs. In this chapter the related issue of *loan* (not project)[1] portfolio management and quality control is taken up in greater depth. Managing portfolio quality and arrears was a relatively undeveloped area of financial policy in the MDBs for the first forty years of the IBRD's existence and the first 20-25 years of the AfDB, AsDB and IDB. It emerged as a key policy concern when the debt crisis engulfed a large number of countries in the 1980s in Latin America, the Caribbean, the Philippines in Asia, several countries in North Africa and the Middle East and nearly all the low-and lower-middle income countries of sub-Saharan Africa. The debt crisis continues to persist in the 1990s. But it no longer affects as severely the Latin American and other middle-income debtors whose creditors were principally private commercial banks. Instead it is now concentrated mainly in: the low-income sub-Saharan African countries; the lower middle-income countries of the Caribbean (e.g. Jamaica); several countries in Eastern Europe (e.g. the former Yugoslav republics); and, in particular, Russia. The main creditors in these instances are mainly OECD and Arab-OPEC governments, the IMF and the MDBs (including some of the smaller sub-regional and Arab funded MDBs) themselves rather than commercial banks.[2]

There are some other countries, not generally viewed as debt-distressed, which are large debtors to the MDBs and have recently flirted with economic

1 Project portfolio management refers more to the regular Operations Evaluation exercises that MDBs now undertake as a matter of routine and to the periodic overall reviews of the project portfolios of the various MDBs such as those recently undertaken by Wapenhans for the World Bank, Qureshi for the IDB and Knox for the AfDB. Such exercises are aimed at improving the quality of MDB operations rather than the quality of their financial assets as such although the two are inextricably linked.

2 For recent discussions about the continuing debt crisis, see for example, (1) Mistry, P.S., "Multilateral Debt: An Emerging Crisis?", FONDAD, The Hague, Netherlands, 1993; (2) Report of the Non-Aligned Movement Ad Hoc Advisory Group of Experts on Debt, "The Continuing Debt Crisis of the Developing Countries", South Centre, Geneva, 1994; (3) The World Bank, "Reducing the Debt Burden of Poor Countries: A Framework for Action", World Bank, Washington DC, 1994.

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crises of varying severity. Their debt situation is either troubling or on the borderline of being debt-distressed. These include MDB borrowers such as, for example, India, Indonesia, Pakistan and Turkey. What differentiates them from the incontrovertibly debt-distressed countries is that their recovery and growth prospects, are promising. The debt service ratios of these countries, once troubling, have been brought under control and are becoming increasingly manageable with time. If, however, their current trajectories of reform and economic resurgence are, for any reason (political turmoil or inability to sustain the tempo of reform), interrupted for any length of time, it is conceivable that the quality of MDB portfolios, which is presently unaffected by these countries, could again come under considerable strain. For that reason, the *ex-ante* control of portfolio risk through country risk exposure management, and the *ex-post* management of protracted arrears through sanctions, non-accrual and provisioning policies, remains a challenge for MDB financial managements. Portfolio quality control also constitutes the main area in which MDB financial and operational policies overlap; requiring the greatest amount of interaction and cooperation between the financial and operational staff in an MDB.

A difficult set of questions arises in reviewing the conduct of the MDBs (and especially the IBRD and AfDB) with respect to the quality of their loan portfolios. Does the automatic availability of borrowing government guarantees for every MDB loan, coupled with their status as preferred creditors, make MDBs less diligent about quality and risk in making these loans than they otherwise might be? Are the MDBs putting themselves in a conflict-of-interest situation with respect to portfolio quality when they get involved in every aspect of a project or programme from its conception and design to its pre-appraisal, appraisal and supervision? Can they be sufficiently objective in appraising a project or programme which they have designed themselves? When they are so deeply involved in designing the investment or the adjustment programmes which their loans finance, how much of the risk should the MDBs themselves bear for the failure of their projects or programmes to work or to deliver the anticipated economic and financial benefits? Have the MDBs compounded the debt service problems of their borrowers by their own lending actions and thus contributing to worsening the quality of their own loan portfolios? All these are valid questions. But they are difficult to answer unequivocally. They raise fundamental issues which need to be explored more thoroughly than most MDB managements would like them to be. Upto now, MDBs have invariably sought the protection of their preferred creditor status in requiring their loans to be repaid regardless of the conditions in which they were made and ignoring the role that they themselves might have played in contributing to the impairment of a particular borrower's debt servicing capacity. This issue is

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brought up as a preface to this chapter in order to raise consciousness and provoke a change in the kind of thinking that is done by MDB managements and staff.

Country and Portfolio Risk Exposure Management

All the MDBs now have systems for assessing, on a rigorous annual basis, the risk of protracted arrears and non-payment on debt owed to them (individually and collectively) by their borrowers. These systems vary in their degree of sophistication. The AfDB was the last to introduce such a system in 1993 while the AsDB and IDB have moved toward adopting systems involving the same rigour as that of the IBRD; if not being quite as elaborate or expensive. Following a careful review of their circumstances, borrowers are now classified in MDB portfolios into different risk categories on the basis of their: GNP income levels; economic structures, characteristics and performance; debt profiles (i.e. term structure, creditor composition, vulnerability to unforeseeable shocks); and actual debt service performance. These country-by-country risk assessments[3] are aggregated into an overall assessment of portfolio risk[4] each year through the application of intuitive or explicit scoring techniques which are refined continually with experience. Such portfolio assessments combine the judgement of the MDB's operational staff dealing with each country as well as financial staff experienced in assessing portfolio risk.

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3 Broadly defined **country risk** represents the probability that an MDB will suffer a loan loss in a country due to events which are both within the control of the government as well as those over which it may have limited or no influence. Country risk is affected by a number of internal and external economic, political and natural factors which interact to determine a sovereign government's willingness and/or its ability to service an MDB's debt through the provision of sufficient funds *in convertible currencies* to meet its debt service obligations to that MDB.

4 The overall **portfolio risk** is represented in the IBRD, for example, by a portfolio score ranging on a scale from 0-100 where zero represents no risk and 100 represents the risk of the entire portfolio being in default. In a 1993 review the IBRD rated its overall portfolio at a score of 61 which was regarded as uncomfortably high. By comparison the portfolio score was only 37 in 1980, 53 in 1985 and 59 in 1990. The outlook for any MDB's portfolio essentially depends on four interrelated factors: (i) the overall *strength of the world economy* and especially of growth and market demand in the OECD countries; (ii) the *political environment and policy stance of borrowing countries* individually and collectively; (iii) portfolio risk caused by the *MDBs' own lending and disbursement plans* – for example, in a large negative net transfer situation, MDBs can exacerbate the risk on their own portfolios whilst, at the same time, continued lending to high-risk countries for portfolio reasons may mitigate short-term repayment risk but exacerbate that risk in the medium and long-term; and (iv) *portfolio concentration;* i.e. the fewer the number of borrowers which account for the bulk of any MDB's portfolio, or the lower the credit quality of those borrowers, then the higher is the vulnerability of that MDB to portfolio default risk.

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Individual country risk assessments are reviewed at two or three levels of management (divisional, departmental and vice-presidential) in the operations complexes of the MDBs. They are aggregated (jointly by working groups comprising operational and financial staff) into an overall portfolio review which is considered by high-level management committees in the financial and operating complexes of each MDB and finally at the apex; i.e. by the managing committee in the IBRD or its equivalent in each MDB. Given their nature and sensitivity, as well as the political difficulties and controversies that MDB managements' judgements on any particular country's credit risk profile invariably cause, such reviews are kept confidential by MDB managements and not publicly shared. The Executive Boards of the MDBs are of course informed of overall portfolio risk assessments, as well as individual country assessments for those borrowers which are in protracted arrears and therefore in non-accrual and/or provisioning status.

Country Exposure Limits in the IBRD

All the MDBs have formal or informal country exposure limits of one sort or another. The **IBRD**, which has the most globally diversified, and therefore the least concentrated portfolio of all the MDBs, also has the most sophisticated country exposure risk management system. It emphasises the importance of detailed analysis and applies three main guidelines to limit its exposure risk. These are meant to guide judgement rather than to substitute for it. *First*, the IBRD has a single country exposure limit of 10% of disbursed and outstanding loans not being accounted for by more than any one borrower and applies an informal accompanying guideline that its *ten* largest borrowers should not generally account for more than 60% of its portfolio. At the end of FY94, however, its largest borrower (Mexico) accounted for 11.9% of the disbursed and outstanding portfolio while its ten largest borrowers accounted for just over 62% of the portfolio. The *second* guideline stipulates that the IBRD share of any country's public and publicly guaranteed *debt service* should not exceed 20% with the share of all *preferred creditors* together not exceeding 35%. The *third* guideline requires the debt service ratio for the World Bank's debt to be confined to 4% of total exports (goods, services and remittances) for high risk countries, 5% for moderate risk countries or upto 6% for low risk countries.

These guidelines are applied with flexibility and discretion on the part of IBRD's management rather than serving as rigid cut-offs which are mechanically applied. Taken together they serve as useful quantitative indicators of the extent of the IBRD's exposure in individual countries. Until country risk actually materialises, the numerical probability which expresses the likelihood of its occurring is more a matter of finely tuned judgement than of formula-

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driven quantitative methodology. The country risk which exists in any particular case, indicated in composite form by these different quantitative signals, actually depends on overall borrower creditworthiness, the claims of other creditors and especially other *preferred* creditors, the government's performance record in improving domestic resource mobilisation and rapidly adjusting to external shocks and, finally (perhaps even most importantly) the overall quality and effectiveness of its relationship with the IBRD. Given this reality, a great deal of supplementary qualitative analysis is undertaken to make a judgement as to whether, in the event of indicators signalling trouble ahead, the IBRD needs to adjust its assistance strategy to a particular country sufficiently early to stop a problem from becoming a crisis. In practice, the IBRD's exposure guidelines are used to identify cases where close monitoring of country creditworthiness is indicated. The IBRD's exposure increases are then calibrated carefully to avoid increasing exposure too rapidly in difficult situations while ensuring, at the same time, that resources are not withheld too hastily so as to precipitate, rather than avert, a debt-service problem.

Country Exposure Limits in the AfDB

In 1993, responding to the concerns of non-regional shareholders about deteriorating portfolio quality, the **AfDB**'s management suggested to its Board the adoption of formal country exposure guidelines requiring that: (i) the amount outstanding on loans to any single borrower should not exceed its ordinary reserves – translated into a proportion of its outstanding loan portfolio, that restriction meant that, at the end of 1993, no single borrower should have a portfolio share larger than 10.5%; (ii) the annual debt service obligations to AfDB should not exceed 4% of a country's total debt service; (iii) the AfDB's outstanding loans to any borrower should not exceed 40% of its total debt stock; and (iv) the AfDB's share of debt service to preferred creditors should not exceed 25%. At the end of 1993, outstanding loans to three borrowers (Morocco, Nigeria and Tunisia) accounted for 14.7%, 11.8% and 12% of the total AfDB loan portfolio respectively. In 1993 the share of AfDB debt service in total debt service exceeded the 4% criterion in the case of 36 countries. The AfDB's share of total debt stock did not exceed 40% in the case of any borrower. As a share of debt service to preferred creditors, the AfDB's share exceeded 25% in 24 small countries.

Hence most of AfDB's exposure guidelines, if adopted immediately by the Board, would be honoured more in the breach than in the keeping. Therefore, at present they are statements of *intent* rather than of applicable *policy*. The *share of portfolio* criterion, as expressed in the AfDB's guidelines, may not be an appropriate rule to apply. It may even be unmanageable in that neither commitments, nor contractually obligated disbursements, can be

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controlled in a manner which reflects AfDB's ability to generate adequate reserves. Therefore a criterion which limits the largest borrower to 10% or even 15% of its total portfolio (regardless of the level of *reserves*, which would be built up through a reserves-to-loans ratio anyway) might be a more easily applicable guideline. Moreover, given its much smaller eligible borrowing universe for hard-window resources, the AfDB's portfolio will, necessarily, be more concentrated than the IBRD's; therefore it needs to use a criterion which reflects that reality. In using the *share of preferred debt service* criterion, a share of 25% or even 30% would be justifiable as it is conceivable that in the smaller African countries the AfDB's exposure may need to be larger than that of the IBRD. It already is, in unjustifiable cases (such as Zambia). The *share of total debt service* criterion needs to be in balance with the *preferred creditor share of debt service* criterion. But, in the case of African debtors, whose debt servicing patterns are not usual or typical in comparison with those of most MDB borrowers, considerable caution has to be applied in interpreting this criterion.[5] Finally the *share of debt stock* criterion might appear to be a useful guideline, but it is not from an operational viewpoint. For such a guideline to have any meaning, the creditor composition of a country's debt stock, its term structure and concessionality, and the contractual debt servicing obligations it imposes, need to be taken into account. Because the need for useful exposure monitoring guidelines, which are realistic and applicable, is greater for the AfDB than for any other MDB, its proposed guidelines need to be reconsidered and redesigned.

In September 1992 the AfDB issued a policy paper on Country Exposure[6] and in April 1993 issued Terms of Reference for its internal Exposure Monitoring Committee.[7] These documents acknowledge the need for careful and continuous portfolio monitoring through quarterly reviews. Quite appropriately, and in keeping with portfolio review practices at the IBRD and IDB which reflect the sensitivity of the judgements involved, the AfDB

5 It should be interpreted on the basis of *contractually obligated* (i.e. *scheduled)* and not actual, debt service in any given year. Most African low-income debtors today are servicing only preferred creditor debt. In doing so, they are giving seniority to servicing AfDB debt rather than the debt of other preferred creditors such as the IMF, IBRD and other multilaterals (EDF, EIB and the Arab multilaterals). For example, Sudan is servicing AfDB debt but not that of the IBRD or IMF. The same is true for a number of African countries. Thus the proportion of total debt service which is absorbed by the AfDB seems inordinately high on an actual basis when it would be much lower if these borrowers were meeting all their scheduled, contractual debt service obligations.

6 AfDB Board Memorandum on "Country Exposure Policy" dated 14 September 1992 (No. ADB/BD/WP/92/95).

7 AfDB Board Information Note on Terms of Reference to Exposure Monitoring Committee dated 8 April 1993 (No. ADF/BD/IF/93/32).

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emphasises strongly the internal ownership of the exposure review process. But, a close scrutiny of the documentation (especially the September 1992 paper) suggests areas in which concern might legitimately be expressed by shareholders about how rigorous the exercise might be. While making a powerful case for ongoing exposure review and recognising the concentration of the AfDB's portfolio in severely-indebted, low-income countries (in most instances *IDA-only* countries), the stated policy contains several loopholes which do not appear justifiable on substantive grounds. In outlining exposure control policy the paper at the same time makes a case for deviating from strict standards in the name of *flexibility* when the AfDB's current financial situation demands the opposite approach. For example:

> Para 5.2 "However, since the AfDB is a regional bank it also needs more flexibility in the application of exposure guidelines. The AfDB services a smaller number of borrowers than the World Bank, and the resources and absorptive capacity of its borrowing members are concentrated in a smaller number of countries, *so exposure guidelines should be tailored to meet a specific regional need.*"
>
> Para 5.3 "Management therefore proposes to introduce more rigorous supervision of the Bank's funds. It will not however put an automatic mechanism into place *which prohibits the flexibility needed to take into account the variety of economies found among regional members.*"
>
> Para 5.4 "Management wants not only to flag countries which may present exposure concerns to the Bank, but to *develop an active policy which will help augment the member countries' absorptive capacity and their growth rates.*" (italics by the author)

These loopholes – which imply that AfDB's management should retain the right to avoid doing what a rigorous approach to portfolio risk management might necessitate – may only serve to vitiate whatever benefits a country exposure policy and a review process might have. Under the financial situation which is presently evolving in the AfDB, the arguments actually favour permitting *less* flexibility and discretion on the part of management. The AfDB's highly politicised regional representation on its Board tends to take advantage of management discretion through special pleading which a politically-sensitive management finds extremely difficult to ignore. That practice explains, in part, the predicament in which the AfDB finds itself. For that reason alone, it is essential to introduce greater automaticity in requiring the AfDB to reduce country exposure levels rapidly, especially in patently uncreditworthy countries, unless there are sound reasons for doing otherwise. For the same reason there might also be grounds for having a small sub-committee of the Board (comprising mainly its non-regional members), or even the Audit Committee, participate in the portfolio review exercise, without usurping the prerogatives of the Bank's management, to ensure a

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needed degree of transparency in the application of an overdue and critically important country exposure policy.

Country Exposure Limits in the AsDB and the IDB

Both the **IDB** and **AsDB** have country risk assessment systems with provision for annual reviews. But, in view of the limited number of regional borrowers that avail of their OCR facilities (much more limited in the AsDB than in the IDB) their approach to having firm guidelines and enforcing exposure limits was, until very recently, a deliberately flexible and cautious one perhaps best expressed by the AsDB in asserting that, while it is important to avoid making an unduly large share of the total loans to any one borrower, and to ensure that the general portfolio mix is carefully determined, care needs to be exercised in considering the establishment of any fixed limit or ceiling for lending to any one country. That view, expressed in March 1993, changed suddenly. In June 1993, the AsDB opted for a country risk exposure management approach similar to the IBRD's, adopting the latter institution's guidelines for an interim period while leaving open the possibility of modifying these after sufficient experience had been gained. The IDB's country exposure practices have not yet followed the guideline-based practices of the AsDB or IBRD although plans to do so are quite advanced.[8] In the IDB, country exposure is, of course, implicitly and automatically limited by the detailed fashion in which lending plans for its four different categories of borrowers are laid out when shareholders are approached for periodic GIRs, coupled with annual and end-of-period reporting on how those plans are being (or have been) executed.

At the end of 1993, about 36.3% of the **AsDB's** portfolio of OCR loans was concentrated in Indonesia, with a further 41% in three other countries (India, Pakistan and the Philippines). Two countries (China and Thailand) accounted for a further 13.4%. Just six borrowers thus accounted for nearly 91% of AsDB's total OCR portfolio. This is the highest level of portfolio concentration in any MDB except the nascent EBRD. Were significant economic or political disturbances to occur in any of its four largest borrowers – none of which are immune to such risks – the AsDB could be exposed to a degree of risk much higher than any of its cohorts. Upto now, (and throughout the debt crisis) the debt-service record of its major

8 It was reported that IDB was working on formulating a formal guidelines based country risk exposure monitoring system and was to present a paper to its Board before the end of 1993. That deadline has passed without any public knowledge that such a system has in fact been put in place.

borrowers has, however, been exemplary by any standards; even during periods when they have been severely traumatised by internal economic and political crises (the most recent case being India in 1991). If that record can be maintained in the future, then the AsDB's concentration risk, although very high, may not be much of an issue. What this degree of concentration does suggest though is that it may not be appropriate for the AsDB, even during the trial period of running-in its new country exposure risk management system, to adopt, without modification, the *single-country share of portfolio* guideline used by the World Bank. The other IBRD risk exposure guidelines of course are unobjectionable and relatively easy to adhere to.

The portfolio of the **IDB** was somewhat less concentrated at the end of 1993 with the largest OCR borrower (Brazil) accounting for 16.2% of the total portfolio and five other borrowers (Argentina, Chile, Colombia, Mexico and Venezuela) accounting for a further 51% with the risk being more evenly spread among these six borrowers than in AsDB. Unlike the AsDB, the IDB did have a number of troubling years with protracted arrears since, at one time or another, all of its six largest borrowers, and a number of smaller ones (accounting for almost the rest of the portfolio) were severely affected by the debt crisis. However that crisis has now passed though it has left a salutary legacy of prudence in anticipating problems and building up provisions and reserves.

Country Exposure Limits in the EBRD

Given the limited number of sovereign borrowers that it deals with, the **EBRD's** start-up approach to country risk exposure focuses on the extent to which: (i) these individual borrowing countries have the capacity to service external debt obligations in general and EBRD debt in particular; and (ii) the EBRD's status as a preferred creditor, relative to other preferred creditors, is honoured.[9] As in the other MDBs, country risk is determined by using both quantitative measures and qualitative judgements. Quantitative measures include an evaluation of the usual macroeconomic indicators (i.e. debt stock, debt service, export earnings and growth, GNP growth, inflation performance, reserves and current and capital account balances). In addition the EBRD bases its country risk judgements on credit ratings provided by the

9 Unlike the other MDBs it should be recalled (as mentioned in Chapter 2) that the EBRD is explicitly required under its Charter to limit its exposure to the "state sector" (i.e. to sovereign governments or their entities) to 40% of its total committed loans, guarantees and equity investments and to direct at least 60% (preferably more) of its operations to the private sector in a direct effort at supporting the emergence and development of market economies in its eligible borrowing countries.

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Institute for International Finance (IIF) and the commercial rating agencies, as well as on its own internal judgements about a country's ability and performance in: moving towards a market economy; economic diversification; internal economic and political stability; and the management of budgetary deficits. Quantitative and qualitative indicators are combined in determining the EBRD's rating of country credit risk.

EBRD uses two specific exposure guidelines: (i) annual debt service to *preferred creditors* – which in the EBRD's definition also includes debt service on bonds issued in debt stock and debt service reduction exchanges and short-term trade related credit – should not exceed 20% of a borrowing country's total export earnings; and (ii) annual debt service to EBRD should not account for more than 5% of total export earnings. If these two guidelines are breached, an intensive credit review is required before a lending operation is approved. As in the other MDBs, the EBRD's country lending limits reflect its concerns about risk diversification and are not used as a lending allocation or rationing device.

Individual country risk assessments are integrated into an annual loan portfolio review which is presented to the Board. Statutorily, the maximum amount of *committed* loans, guarantees and equity investments made to/in both state and private enterprises in any single country cannot exceed 90% of the EBRD's paid-in capital.[10] The limit for each country is related inversely to the assessed risk; as risk is perceived to decrease, the allowable exposure is permitted to rise to the present maximum exposure limit of ECU 2.7 billion (or US$3 billion). The absolute size of the country plays a role in determining the exposure limit as does the size related to risk. The EBRD will not permit total exposure to approach the allowable limit in either high-risk large countries, or low-risk small countries. Given the incipient stage of growth in EBRD's lending operations, the individual country limits are not expected to be reached for several years and country exposure management will be refined annually as more experience is gained.

At the end of 1993, two countries (Hungary and Russia) accounted for 50.6% of the EBRD's disbursed and outstanding portfolio while three of its next largest borrowers (the Czech Republic, Poland and Romania) accounted for a further 39%. These patterns indicate a reasonably high level of start-up concentration risk although the amounts involved do not yet pose a market

10 At least 60% of EBRD's aggregate OCR loans, guarantees and equity investments outstanding at the end of each fiscal year between FY92 to FY94 are to be in: Albania, Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovak Republic and the constituent republics of the former Yugoslavia.

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risk of any significance since the total loan and investment portfolio amounts to a fraction of its paid-in capital at the present time.

Private Sector Exposure Risk Management

Three of the MDBs (i.e. the AfDB, AsDB and EBRD), finance *private sector operations* directly through their own hard-windows rather than through separate affiliated corporations. The IBRD, finances the private sector through IFC, and the IDB does so through IIC. In the former case, risk assessments of loans to *private* borrowers must also be made by the three MDBs for portfolio risk management purposes. Lending to and investing in private borrowers involves different risks from sovereign risk, insofar as these loans/investments are not guaranteed by a sovereign. Direct lending to *private* borrowers exposes MDBs to standard commercial risks which sovereign lending does not, especially when sovereign borrowers are also shareholders in the MDBs. Loans and equity investments in *private* enterprises also expose MDBs to the risk of outright loss, whereas with *sovereign* borrowers, the risk – except *in extremis* – is more that of incurring protracted arrears and their consequences than of outright capital loss.

Moreover, in dealing with private borrowers, MDBs might be compelled to engage in normal *debt* rescheduling, refinancing and restructuring arrangements alongside other creditors which, if indulged in on a large scale, could endanger an MDB's own credit rating on international capital markets and increase its cost of borrowing and/or constrain its market access. Three issues therefore arise in ensuring that the impact of private sector lending/investment on adding to an MDB's portfolio risk is contained: (i) the size and nature of its private sector operations; (ii) the loan restructuring and rescheduling practices to be employed for such operations and (iii) the separate provisions set-aside for such operations to ensure that losses on *private* lending do not contaminate the MDBs' *sovereign* portfolio.

Direct lending to, and investment operations in, the private sector by the **AfDB** are minuscule in relation to its total operations. This is a relatively new activity for the AfDB, launched in 1991 with an allocation of UA150 million for private sector projects through a separate private sector development unit (PSDU). By the end of 1993, the AfDB's cumulative lending to the private sector amounted to UA39.5 million (US$54.3 million) for 14 operations out of total cumulative lending of UA13.26 billion (US$18.2 billion). Private sector lending operations thus accounted for less than 0.3% of total operations, although they accounted for 2.2% of annual operations in 1993. In addition to its strategic equity investments in a few plurilateral African institutions and in national and sub-regional development banks, the AfDB has made three equity investments in private companies of just over UA1.5

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million (US$2.1 million).[11] But it is planning a rapid expansion of its private sector operations in the coming years.[12]

The AfDB has given much thought in the last year to revising and strengthening its approach to controlling its burgeoning arrears. But its focus of attention has been on controlling arrears on sovereign, rather than private, loans/investments. Its policies on exposure in private sector loans and investments, and on arrears on loans to private borrowers, or on losses on equity investments in private companies have the same foundations as in the AsDB and EBRD (see below). AfDB's private sector loans are secured by collateral; ostensibly at least it undertakes intensive supervision and monitoring of the private sector projects it finances. Private sector loans which are more than 90 days overdue are classified as non-performing with non-accrual and provisioning being triggered at that point. The AfDB's policies require it to establish specific reserves for potential losses on its private sector loans and investments. Its policies also permit it to participate in various types of debt relief and rescheduling measures for private sector loans operations provided that doing so enhances the prospects of recovery and provided that such arrangements involve fair burden-sharing by all creditors and shareholders.

In its 1993 Accounts, the *carrying values* and *estimated fair values* of all disbursed and outstanding *loans* to the private sector (of UA5.53 million or US$7.6 million) were identical, suggesting that their repayment record till then did not require any provisions for possible losses to be made. But, in the same year the AfDB adopted a policy of reviewing periodically its portfolio of all its *equity investments* (including both strategic investments and those made by PSDU) and creating specific provisions for those in which management expected there to be a significant and lasting decline in value. Accordingly, in its accounts for 1993 the AfDB made a provision of UA2.44 million (US$3.35

11 This amount excludes the equity participation by AfDB in major public, or quasi-public institutions such as the core capital of the AfDF, and in the common equity of the Africa Reinsurance Company (Africa-Re), the SIFIDA Investment Company, Shelter-Afrique, Meridien BIAO S.A., African Export-Import Bank, as well as several public national and sub-regional development banks in Africa, such as the East and West African development banks and the PTA Trade & Development Bank. Of these, the investments in SIFIDA and Meridien could be considered purely private investments although they are different (and more strategic) in character to the smaller investments in local private companies which AfDB is undertaking as part and parcel of its regular business operations through the PSDU. In total, the AfDB's strategic equity participations in these larger institutions amounted to UA138.3 million (US$190 million) at the end of 1993 of which UA111.74 million (US$153.5 million) was accounted for by the AfDF with the remaining UA26.6 million (US$36.5 million) invested in the other pan-African institutions which AFDB has helped to establish.

12 See for example, President's Memorandum to the Board on "Mid-Term Report of the AfDB's Private Sector Operations" (Document No. ADB/BD/WP/93/131) dated 9 December 1993.

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million) for possible losses on its equity investments. This amount represented about 9.2% of all its outstanding equity investments other than its investment in the core capital of the AfDF. No information was readily available on the procedures and policies which the AfDB applies to arrive at such provisions relative to its total equity portfolio.

In the **AsDB,** private sector operations (which actually began in 1983 with the establishment of a special equity investment facility) are also seen as a separate activity from mainline sovereign lending business. The amounts allocated for private sector lending and investment over an operational programme period are considered and pre-decided by the Executive Board. In 1990, the Board agreed to set the limit for such operations at a total of US$1 billion before it became necessary to review the matter again. By March 31, 1994 cumulative lending and investment by the AsDB directly to the private sector totalled US$947 million in about 100 separate operations.[13] It expects to commit a further US$1 billion in private sector loans and investments between 1994-96. In 1993, AsDB's private sector operations accounted for under 6.6% of total lending operations and represented about 2.3% of the disbursed and outstanding portfolio. Apart from its policy of limiting its overall private sector exposure to a prudent level, the AsDB employs different credit policies for its private sector lending and investment operations to assure strong asset quality. Unlike its sovereign loans, the AsDB's loans to the private sector are fully secured by collateral. Private borrowers are required under loan and investment covenants to maintain satisfactory financial ratios, ensuring financial soundness and ability to meet debt service obligations, which are closely monitored on a regular basis to enable early detection of potential problems. Even so, the AsDB acknowledges that by their very nature, such operations involve a higher degree of risk in incurring potential losses and delays in recovering loans. Therefore, unlike the firm position it (and every other MDB) has taken on **not** rescheduling, refinancing or restructuring *sovereign* debt, the AsDB like the AfDB does engage in such rescheduling, under strict guidelines,[14] for loans and investments in its private sector portfolio.

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13 As the AsDB observes in a confidential document, there is a limit to the amount of resources that can be allocated for private sector financing beyond which it would have to: (i) change its financial policies and practices in a fundamental manner and (ii) be provided with additional paid-in usable capital by shareholders to support expansion of such operations. Equity investments in private companies are funded entirely from equity capital while private sector loans are funded by both borrowings and equity. AsDB's charter sets a limit on its equity investments to 10% of the unimpaired paid-in capital plus ordinary reserves.

14 Rescheduling is only one of several options which the AfDB, AsDB and EBRD keep open in dealing with problems in their private sector portfolio. Such an arrangement is undertaken only when these MDBs have determined conclusively that: (i) it would improve the prospects of such loans being serviced and eventually recovered; (ii) rescheduling is not being undertaken→

Unlike the AfDB and AsDB, lending to the private sector is a mainline activity of the **EBRD** which is required under its charter to provide (i.e. lend/invest) at least 60% of its total resources to the private sector. In the EBRD, the private enterprise portfolio is limited by a series of prudential exposure limiting guidelines which are to become effective from January 1995 onwards. These include: (i) a *sectoral or industry exposure limit* of 20% of the outstanding portfolio; (ii) a *single obligor*[15] limit of 5% of EBRD's paid-in capital (effectively ECU 150 million or US$167 million) which applies to both private enterprises or state-owned enterprises whose obligations to the EBRD are not guaranteed by a member government; (iii) committed *equity investments in a single obligor* limited to a maximum of 3% of EBRD's paid-in capital (ECU 90 million or US$100 million at present); (iv) the *five largest* private or non-sovereign risk commitments are limited to a maximum of 50% of the portfolio; and (v) normal EBRD financing for any *single project* is limited to 35% of the long-term capital needs of any obligor.

Like the other MDBs, the EBRD has a general policy of not rescheduling, refinancing or restructuring its loans to *sovereign* borrowers or state enterprises in order to preserve its privileges as a preferred creditor. But, like the AfDB and AsDB, the EBRD's policies permit it to engage in such practices where its lending to the private sector is concerned. And it employs much the same rationale and safeguards in doing so. Its policy posture is to undertake loan rescheduling where such a course of action provides the best means of protecting its own interests. The determination of the circumstances in which such a course of action is deemed correct is left to the discretion of management subject to the application of the following general principles: (i) whenever possible, an EBRD rescheduling is made conditional on other investors and creditors sharing equitably the burden of the problems faced by the borrower through further injection of equity, debt or both; (ii) the rescheduling, along with actions taken by other parties involved, must

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simply to avoid default; (iii) other courses of action, including liquidation, have been carefully considered and found to be less desirable or appropriate than rescheduling; (iv) the arrangement is properly coordinated with other creditors and shareholders to ensure consistency of treatment and the workability of the approach being taken; and (v) interest and restructuring charges can be applied on an appropriate basis, depending on the circumstances, to the rescheduled component. Authority is delegated by the Executive Board to the MDB managements to approve changes in loan repayment dates (in situations that do not involve basic or material changes in the scope of the project financed or in implementation arrangements) without prior approval by the Board providing the latter is kept informed of such actions through quarterly progress reports.

15 A single obligor is defined by EBRD as: (i) a single borrower, or (ii) a group of borrowers which are either majority-owned or effectively controlled by a single entity. For example, the total committed loans, investments and guarantees to two or more companies which are owned to the extent of "50% + one share" owned by the same parent company or the same shareholder cannot together exceed the limit applicable to a single obligor.

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enable the borrower to achieve viability and service future financial obligations out of regular cash flow; (iii) all reschedulings which postpone repayments beyond time limits originally authorised by the Board must again be approved by it; (iv) rescheduling actions must be determined on a case-by-case basis to suit the particular needs of a specific borrower; (v) reschedulings are only undertaken after all the other options (including liquidation) have been thoroughly evaluated and determined to be less desirable; and, finally, (vi) rescheduling is not undertaken merely to avert an imminent default.

At the end of 1993, the EBRD had committed a cumulative ECU1.6 billion (US$1.79 billion) to the private sector of which it had disbursed just over ECU0.49 billion (US$0.55 billion). The private enterprise sector thus accounted for 89% of EBRD's disbursed and outstanding loans/investments. Against this portfolio, the cumulative *general* provisions set aside for possible losses amounted to ECU11.1 million for loans and ECU10.6 million for equity investments at the end of 1993. In addition, *specific* provisions of ECU12.5 million were made for three projects.

To avoid the risk that problems with their private sector portfolios might contaminate their sovereign loan portfolios, it would appear wiser for the AfDB and AsDB to consider financing their private sector operations through a separate corporate entity with limited liability and a different *modus operandi* with different policies, rules and regulations applying to its management and staff. The EBRD has, of course, been constitutionally structured to be a hybrid whereas the other MDBs have not. For that reason it may be more appropriate for the AfDB and AsDB to follow the route taken by the IBRD and IDB in establishing the IFC and IIC respectively. The AsDB has already participated in the establishment of the Asian Finance and Investment Corporation (AFIC) to which all of its private sector operations could easily be shifted. The AfDB may need to either participate in, or establish its own, African Finance Corporation. In the absence of such an approach, there is a real danger that any significant losses on the institution's private sector portfolio could impair the market image and operations of the MDB as a whole. This risk is perhaps particularly high in the case of the AfDB. Clearly in creating distinct corporate vehicles for this purpose, the two MDBs concerned should avoid duplicating unnecessary administrative functions, infrastructure and costs to the extent feasible. The suggestion to take a separate corporate route in handling private sector operations is made not because uniformity of approach across all the MDBs on all matters is *per se* good or essential. It is not. Instead the proposal is intended to safeguard the prudential interests of these institutions and to permit more flexibility to be applied in the way these operations are handled, and the way in which remedial measures can be applied when portfolio problems occur.

Policies for Arrears, Non-Accruals and Loan Loss Provisioning

Despite their best efforts at trying to anticipate potential debt servicing problems through their country and private sector risk exposure management practices, different MDBs have, since the mid-1980s, experienced *arrears* on the servicing of debt owed to them by their sovereign and non-sovereign borrowers. These arrears have been of varying severity at different times and have been incurred by different sovereign and private borrowers. The experience of the MDBs in coping with such arrears and their consequences is only about a decade old. During that time, the policies and approaches of the MDBs in dealing with the problem of arrears, and in applying a series of *carrot-and-stick* measures to induce borrowers to reduce arrears and resume debt service on the basis of contractually agreed schedules, have been developed and refined continuously. Between 1984-92, the different MDBs evolved internal approaches which varied significantly. The AsDB and AfDB, for different reasons, adopted approaches which were quite distinct and more lenient than those of the IBRD and IDB. That may have been because, at the time, neither of them faced the same portfolio problems with the same degree of urgency as their two cohorts. Since 1993, however, there has been a trend towards all the MDBs adopting convergent policies and approaches with the IBRD setting the pace. A brief comparative analysis of these policies for the IBRD, AsDB, AfDB, and IDB is provided in summary form in Annex 2.1.

The Problem of Arrears: All the financial managements of MDBs (usually their Controller's Departments) monitor debt service payments on a continuous basis. A borrower is in arrears with an MDB when, in accordance with the applicable loan contract, it has not made payment to the MDB by the close of business on the day when interest and principal repayments are due. As arrears age, MDBs employ measures of progressively increasing severity in order to exert pressure on borrowers to meet their contractual obligations. In formulating these measures, it is of course important for MDBs to take into account the nature and causes of the arrears problem and to work with the borrower in encouraging the latter to make best efforts to clear arrears. In the interests of fairness the measures applied by MDBs need to take into account the size of the arrears, whether they have been caused by technical or procedural difficulties in procuring certain currencies for repayment, and whether the borrower has made acceptable payment arrangements which have not been properly implemented or effectuated. In looking at the policies which the MDBs have devised for coping with arrears it is therefore useful to consider them on the basis of their different durations. For operational purposes (i.e. from the viewpoint of triggering various sanctions and/or loss of various benefits enjoyed by borrowers not in arrears), these are

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classified by the **IBRD** into four different categories: (i) arrears of less than 30 days duration; (ii) arrears between 30-60 days; (iii) arrears between 60-180 days; and, finally (iv) arrears of over 180 days. These same categories are now applicable in the case of other MDBs as well.

Arrears of less than 30 days are generally due to transaction-related complexities and difficulties, most of which are often quickly resolved. Arrears of 30-60 days duration provide more cause for concern and trigger the loss of interest spread waiver benefits (only in the IBRD), some sanctions, as well as more intensive efforts on the part of management to ensure timely repayments. Most countries whose arrears fall into this duration category are usually highly-indebted, confront serious debt servicing difficulties, are low on their reserves and are generally short of foreign exchange. After 60 days, the MDBs suspend disbursements on their other committed loans to the same sovereign borrower while simultaneously intensifying their efforts to prevent borrowers from having their arrears slip beyond 180 days.[16] When payments are overdue for more than 180 days they are referred to as *protracted arrears*; at that point, they trigger both *non-accrual* of income and require *specific provisions* to be made for possible losses on the loan. A borrower being placed in non-accrual status by any MDB reflects an unusual degree of financial distress. It may also indicate an unwillingness or inability on the part of the borrower to take immediately the kinds of measures necessary for restoring economic viability which are deemed adequate by the international financial community to justify the provision of extraordinary external financial support. Experience suggests that after some time most borrowers in non-accrual status do attempt to work out their problems with the MDBs through a series of special measures and approaches aimed at reviving flows of external finance and the restoration of normal debt-servicing relations.

Non-Accrual Status: In keeping with internationally accepted accounting standards, all the MDBs record their *income* from loans on the basis of accrual rather than actual cash receipts in convertible currencies. The same principles

16 The volume of arrears in the two categories of 30-60 days and 60-180 days fluctuates considerably from month-to-month and is usually influenced by overdues of a few large borrowers. Combined arrears in these two categories have been growing rapidly for the IBRD and AfDB since the mid-1980s. They also grew for the IDB between 1984-1990 but have diminished significantly since. In the case of the IBRD *the arrears float* – i.e. the average arrears outstanding between 30-180 days grew from US$32 million in 1985 to a high of US$233 million in 1989 and have fluctuated since; they came down from an average of around US$190 million in 1990 and 1991 to a low of about US$55 million in 1992 but climbed again to US$70 million in 1993. In the AfDB, this float has kept growing from about US$44.7 million in 1988 to US$263.3 million in February 1994.

require, however, that when any doubt arises about the collectibility of such income, it should no longer be recognised. When a borrower is placed in non-accrual status by any MDB, it means that in the judgement of the MDB's management, the debt service difficulties being faced by the borrower in question are sufficiently serious for the MDB to cease accruing income from that loan on its books. Until early 1993, only the IBRD, EBRD and IDB placed *sovereign* borrowers[17] in non-accrual status when payments were overdue by more than 180 days while the AfDB and AsDB did not do so until payments were more than one year overdue. In late 1993 and early 1994, however, the AsDB and AfDB also shortened their overdue periods for placing sovereign borrowers in non-accrual status to six months. None of the MDBs charge any penalty interest on overdue interest payments.

Loan Loss Provisions: Again, internationally accepted accounting principles require that, in the event of a reasonably quantifiable diminution in the value of a receivable (i.e. a loan), a provision equal to the judged diminution in value should be created. Financial institutions such as the MDBs therefore establish loan loss provisions when any loss of *principal* is expected to occur either from outright default, or from the borrower being a prolonged period in non-accrual. The purpose of the provision is to reflect a possible loss in the financial statements of the MDB immediately upon its being recognised. Loan-loss provisions are annual non-cash charges made against income after non-accrual. Cumulative provisions are shown on the balance sheets of MDBs until an actual loss materialises, at which time the amount lost is charged to (i.e. debited from) the accumulated provisions. However, in charging such a loss on its accounts, an MDB does not necessarily forego the legal right to recover the amounts it has charged off. Should it succeed in recovering its losses, such recoveries must then be credited to accumulated provisions. If actual loan losses exceed the total amount of cumulative provisions the excess of the loss must then be charged against the current year's income. Should expected losses not materialise, and instead should the debt-service record and performance of borrowers formerly in arrears improve, then the provisions made by an MDB may need to be reversed and

17 For its private and non-sovereign borrowers the EBRD places loans in non-accrual status when payments are overdue by more than 60 days; a period which is shorter than that used by most commercial banks. It is not clear whether the AfDB and AsDB intend to follow the EBRD in pursuing different policies for their non-sovereign private borrowers as well. Prudence would dictate that they should although a 60-day period before triggering non-accrual seems very short. In keeping with standard commercial practice a 90-day period would be more appropriate for all MDBs to employ. The AsDB presently places private sector loans in non-accrual status when they are 6 months overdue and provides for them at the same time. For its sovereign borrowers its policy is not to provide until loans have been in non-accrual status for six months.

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reduced with the amount of the reversal being added back to the current year's income as extraordinary income.

There are two approaches which financial institutions use in making loan loss provisions. One is the *specific provisions* approach which requires provisions to be made for loans to specific borrowers who are in arrears. The other is the *general provisions* approach under which provisions are made on the basis of an evaluation of the recovery risk on the entire loan portfolio. In those instances where a loan portfolio consists of a large number of homogeneous loans (e.g. auto loans, small business loans, or home mortgages), qualitative judgements about the adequacy of provisions can be augmented by actuarial analysis of the past record of arrears and defaults. In the case of the MDBs, however, the number of borrowers are limited to about 100 in the case of the IBRD and fewer than 40 in the case of the regional banks. Moreover, the history of arrears in the MDBs is limited and concentrated. These characteristics do not lend themselves to an actuarial risk approach for determining general provisions against the whole portfolio.

All the MDBs started out with specific provisioning. The IBRD and IDB shifted in 1991 to a policy of combining aspects of specific and general provisioning with the AfDB following in 1993. The EBRD started at the outset with both specific and general provisioning while the AsDB retains a policy of only specific provisioning. Specific provisions are clearly more defensible than general provisions. But they suffer from the weakness that they deal with problems in retrospect and not those which might arise in the future. Specific provisions deal with risks which *have already materialised* and do not provide any protection against hidden risks which *might* materialise but have not yet done so. For that reason, specific provisioning exposes MDBs to the risk of volatility in net income levels depending on whether a major borrower goes into or comes out of non-accrual status.

In the case of the MDBs (other than the AsDB) provisions are therefore arrived at judgmentally through a process which combines the following steps: (i) estimating provisions for loans already in non-accrual status; (ii) assessing the probability of loans which are in arrears, but not yet six months overdue, going into non-accrual; and (iii) evaluating the probability that a portion of the loans not yet in arrears may also go into non-accrual with particular attention being paid to those borrowers which are in the riskiest credit categories. These judgements are combined to determine an overall level of provisions on an annual basis which are then accumulated over time. Loan loss provisions are triggered simultaneously with non-accrual in the IBRD, EBRD and AfDB. At the IDB such provisions are made at the beginning of the next month after loans have been placed in non-accrual status. At the AsDB no specific policy on loan loss provisions has been developed yet and present practices suggest a case-by-case approach.

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Sanctions on Borrowers in Arrears

In the difficult interregnum between a country going into arrears and going into non-accrual status, different MDBs apply, as aforementioned, a number of incentives and disincentives to induce borrowers to avoid arrears if possible, or alternatively to mitigate their impact. These sanctions differ across the MDBs depending on their particular policies and whether or not they provide certain incentives (e.g. the IBRD's interest spread waivers) to borrowers that make timely payments. By and large sanctions include measures such as:

- *Loss of Eligibility for Interest Spread Waivers*: As indicated earlier, the IBRD has a system of providing interest spread waivers (presently 25 bp) to borrowers that make timely debt-service payments. On accounts in arrears, the *borrower* ceases being eligible for interest waivers after 30 days of the account being in arrears while the *guarantor* (if different from the borrower) loses eligibility after 45 days. No other MDB has, as yet, adopted the same practice although IBRD's experience suggests that this incentive for making timely payments is a powerful one and should be more widely applied across the MDB community.

- *Dissemination of Borrowers Identity*: After 30 days in arrears, all MDBs inform their Executive Boards, through regular reports on overdue debt service payments, of the identity of borrowers in temporary default. Such reports are made: (i) semi-monthly in IBRD; (ii) monthly in the AsDB and AfDB; and (iii) weekly in the IDB. Borrowers in non-accrual status are identified in the notes to the financial statements in the published Annual Reports of the respective MDBs.

- *Board Presentation and Loan Signature Suspension*: In the IBRD and AfDB, *borrowers* in arrears for more than 30 days are prohibited from signing any new loan or guarantee agreements. *Guarantors* of loans in arrears are prohibited from signing loan or guarantee agreements 15 days after the above sanction has been applied to the borrower (i.e. after 45 days of the account being in arrears). In the IDB such suspension occurs immediately upon a borrower/guarantor going into arrears on any of its disbursed loans while in the EBRD it occurs after 60 days.

- *Suspension of Disbursements*: Disbursements are suspended on loans in arrears and when payments are overdue by: (i) over 60 days in the IBRD; (ii) 60 days in the AfDB; (iii) 30 days in the IDB; (iv) 30 days on private loans and 60 days on sovereign loans in the EBRD; and (v) after a review

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by the Executive Board, 60 days in the AsDB. In the IDB disbursements on *all loans* to the same borrower (and not just on the loan in arrears) are suspended after 120 days. In the other MDBs, disbursements on all loans to the same borrower are suspended at the same time as disbursements on the loan in default.

- *New Loan Processing*: The processing of new loans ceases to *borrowers* as soon as: they enter into arrears at the IDB; are in arrears for more than 90 days at the AfDB; while the processing and granting of new loans to *guarantors* of loans in arrears for more than 90 days is suspended 15 days after the above sanction has been applied to the borrower in the AfDB. In the IBRD and EBRD loan processing is continued except in the case of countries in non-accrual (and sometimes even in those countries when a work-out appears feasible) although loans are not presented to the Board or signed until all arrears have been cleared.

- *Cross-Effective Sanctions*: Sanctions and suspensions are made "cross-effective" across the different entities within an MDB group after different trigger points. In the IBRD, sanctions clauses are now triggered automatically and immediately for IDA credits, but not for IFC and MIGA operations. The AsDB has no specific policy on the cross-effectiveness of sanctions. In the AfDB, cross-effectiveness used to be staggered but sanctions have recently become effective immediately for the AfDF and the NTF. In the IDB, sanctions become immediately cross-effective for FSO and IFF funding but not for IIC.

- *Notification to Co-financiers and Suppliers*: All MDB loan co-financiers as well as all suppliers of goods and services under MDB loans are informed by the MDBs of disbursement suspension when it occurs.

These sanctions and other measures employed to manage arrears, including billing practices and other supportive measures are described in comparative fashion in Annex 2.1.

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