



Portfolio Credit Risk Review

EXECUTIVE SUMMARY.....	iii
I- INTRODUCTORY BACKGROUND.....	1
II- OVERVIEW OF THE OPERATING ENVIRONMENT	2
Volatile operating environment and increasing vulnerability of RMC borrowers	2
Threat of systemic risk	3
Challenges of fulfilling the Bank's development mandate and taking additional exposure to stressed countries.....	4
Limited portfolio diversification possibilities and market constraints on hedging opportunities.....	4
III- RECENT DEVELOPMENTS IN THE BANK'S PORTFOLIO RISK ASSESSMENT	5
Shifts in emphasis of risk measurement and assessment methodologies to cope with the Volatile environment.....	5
Shift in emphasis of rating agencies	6
Auditors concerns about the credit migration of the portfolio.....	7
IV- PORTFOLIO QUALITY AND RISK PROFILE.....	7
Portfolio dynamics	7
Portfolio quality.....	9
V- POTENTIAL PORTFOLIO THREATS AND RISKS	13
Medium term portfolio outlook	13
Potential portfolio threats and risks	14
Systemic and contagion risks	15
VI- RISK MONITORING AND MITIGATION.....	17
Portfolio risk monitoring and compliance	17
Main changes to guidelines and methodologies for credit risk management	18
Strengthening the bank's resilience to shocks	19
Development of innovative lending instruments	20
Institutional governance of risk and risk infrastructure	20
VII. CONCLUSIONS	20

EXECUTIVE SUMMARY

Over the last twelve months there have been significant adverse developments in the Bank's operating environment marked by downgrades and negative rating outlook of some of its largest sovereign borrowers and private sector counterparties. Financial market turbulences continue to deepen. The signs of potential economic downturns and the spill-over effects on the Bank's borrowers are beginning to emerge. All these call for active risk portfolio management to cope with higher than potential systemic and contagion risks emanating from these recent developments. Nevertheless, the overall credit quality profile of the Bank's loan portfolio remains good, largely due to efforts made during the previous years to strengthen the risk management framework, upgrade risk infrastructure and tools, and better quality control at entry. Board and Senior Management oversight and active involvement in the risk appetite definition have also contributed significantly to improving the Bank's credit processes.

Notwithstanding the progress made, more remains to be done to further build-up resilience to shocks and stress events, and to ensure that the growth in the non-sovereign operations would not result in unsustainable risks that could jeopardize the Bank's "triple" A rating.

Accordingly, continuous oversight and monitoring is critical. The annual Portfolio Credit Risk Review, part of such oversight and monitoring, this year focuses on stress testing and scenario analysis. It provides the Board with an assessment of (i) developments in the Bank's portfolio risk profile since the last review in October 2010¹ and (ii) measures contemplated/or being taken to mitigate these risks. The report supplements other monitoring tools such as: (i) the quarterly sovereign and non-sovereign portfolio reviews, (ii) the ad-hoc reports on rating updates, and (iii) the special reports, submitted to the Asset and Liability Committee (ALCO) for decisions and actions.

The highlights of the 2011 Portfolio Credit Risk Review are summarized below:

- **The operating environment of the Bank has been volatile.** However, the overall portfolio risk profile remains good, due in large part to the many enhancements made to the Bank's risk management framework, including the proactive measures taken to address the expected negative impacts of the *deteriorating credit environment*.
- **The portfolio growth momentum is maintained above pre-crisis levels** - Following the unprecedented growth rates in 2009 for the sovereign portfolio, approvals and disbursements of the Bank's total lending portfolio have significantly decreased in 2010 but have begun to slowly increase in 2011. *Disbursement/commitment lags continue to be apparent*; hence further efforts should be deployed before approval to ensure the readiness of new transactions from different operational perspectives.
- **Despite increased risks due to the successive downgrades of North African countries and the deterioration of the credit profile of certain private sector borrowers, the Bank remains in compliance with the prudential risk limits.** The Weighted Average Risk Rating (WARR) was 2.65 as of September 2011, below the target range of 3.0 to 4.0. In addition, the Bank has adequately provided for impairment in non-performing loans.

¹ ADB/BD/WP/2010/173

- **The concentration risk profile of the portfolio, although improving, remains high with little scope for diversification** in the sovereign portfolio. The constraining factors on diversification include among others: the credit policy of the Bank and the lack of cost effective hedging possibilities in the current market environment. Such high regional and sector concentrations could affect the portfolio quality. There are several threats and risks associated with the spill-over effects of the ongoing financial market turbulence and socio-political transitions on the continent begin to be felt in these regions and sectors.
- **Stress testing of the Bank's portfolio to systemic risks and extreme default scenarios indicates that the risk bearing capacity is expected to remain strong.** However, to protect the Bank's risk bearing capacity from erosion, Management needs to remain vigilant and indeed continuously improve in the areas of portfolio management, risk mitigation measures and the institutional governance of credit risk.
- **More systematic and integrated Enterprise-wide approaches to risk management**, currently under development, should continue to be strongly encouraged by all stakeholders (Board, Senior Management and Staff) and supported by the departments involved. Enterprise Risk management (ERM) and the risk dashboard implementation are expected to allow for more informed risk decision-making, improved risk reporting and greater accountability for risks. Maintaining the momentum in ERM journey is critical to ensure the long term financial sustainability of the Bank.

A number of measures and future actions, summarized below could be envisaged to ensure sound portfolio growth.

Key Risks	Measures/Actions	Expected Impact
Concentration & Systemic Risks	Programmatic approach for fast disbursing operations	<i>Gradual consumption of risk capital</i>
	Review of the possibility of widening the scope of enclave policy within the credit policy guidelines	<i>Greater Portfolio Diversification</i>
	Hedging instruments	<i>Reduction of Unexpected Loss</i>
Non Sovereign Portfolio Risk Profile	Greater accountability of investment officers through the establishment of deal sheet	<i>Ensuring quality at entry in the portfolio</i>
	Good collateralization and strong guarantees	
	Strong pipeline development	
	Enhanced projects' supervision	<i>Improving Portfolio Management</i>
	Close monitoring of Equity investments and development of early exit strategy	
	Adequate net income transfer to reserves	<i>Increasing risk bearing capacity</i>
Policy Reviews	Development of risk sharing instruments (syndication, trade finance facility)	<i>Reduction of Expected Loss</i>
	Review of the Credit Policy	<i>Under Board Purview</i>

The Board is invited to take note of the assessment of the Bank's portfolio credit risk as of end September 2011 and of the anticipated measures and actions to effectively manage and protect the risk bearing capacity.

I- INTRODUCTORY BACKGROUND

1.1 Over the last few years, the African Development Bank (“the Bank”) has been deploying its balance sheet more extensively, and has substantially increased its lending to both the sovereign and private-sector borrowers in the RMCs. The risk appetite statement of the Bank, approved in May 2011, also calls for further development of non-sovereign guaranteed lending activities of the Bank to ensure relevance to Low Income Countries (LIC) and Fragile States (FS). It was expected that such decisions will increase the overall riskiness of the Bank’s loan portfolio, they would not threaten the Bank’s ability to maintain its “triple-A” rating.

1.2 Since the definition of the Bank’s risk appetite, there have been several noteworthy developments in the Bank’s operating environment that will have implications for the Bank’s future portfolio risk profile. These developments include the macro-economic difficulties and socio-political problems in North Africa (where almost 50% of the bank’s portfolio is concentrated) and the financial market turmoil that may have some spill-over effects on both the RMC borrowers and their banking sector (mainly through the assets^[1] rather than liability sides of banks’ balance sheet and through contagion of Pan African financial groups^[2] operating in the absence of effective consolidated supervision).

1.3 Given the dynamic context, this annual portfolio review in addition to providing the Board with the customary overview and assessment of the risk profile of the consolidated public and private sector portfolios, pays special attention to the Bank’s resilience and capacity to absorb further shock. It also articulates the measures aimed at protecting the Bank’s risk bearing capacity from rapid depletion in the face of these emerging challenges. It complements the quarterly sovereign and non-sovereign portfolios’ reports and special reports to the Asset and Liability Committee (ALCO) of the Bank.

1.4 The document² is structured into 7 sections. Following this introductory background, Section II provides an overview of the operating environment and its impact on RMCs and the Bank’s operations. Section III summarizes recent developments in portfolio risk assessment with a particular focus on changes in methodologies and risk metrics, shifts in rating agencies approach and auditors’ views. Section IV assesses the portfolio quality and risk profile, focusing in particular on approval dynamics, disbursements and cancellations driving the portfolio’s average risk rating and exposure concentration. Section V examines the portfolio prospects, threats and risks by focusing on the evolution of the Bank’s portfolio under different scenarios and its ability to withstand several stressed scenarios. Section VI presents actions and measures required to build resilience and mitigate portfolio risks while Section VII draws some conclusions and makes recommendations.

^[1] Some countries hold significant amount of Assets in Europeans banks as per recent BIS statistics

^[2] These are essentially Stanbic, Bank of Africa, Ecobank, United Bank of Africa, Atlantic Bank

² This report is a portfolio credit risk review and not a portfolio management document.

II- OVERVIEW OF THE OPERATING ENVIRONMENT

2.1 The Bank operates in a very challenging and evolving environment, which continues to shape the future portfolio risk profile. This is compounded by the necessity to service different types of clients with diverse needs: (i) Low risk investment grade and non-investment grade MIC countries with high absorptive capacity located mostly within the North Africa region. They are experiencing socio-political problems and credit rating downgrades; (ii) Low risk MIC countries with stable outlook and small absorptive capacity; and (iii) Low Income Countries (LICs) eligible only for non-sovereign guaranteed lending with relatively small credit limits. Some of them have recently come out of debt relief. The Bank's credit risk exposure is also concentrated essentially in the first category that accounts for approximately 50% of the total disbursed and undisbursed portion of the portfolio. This makes the Bank's portfolio vulnerable to any adverse developments in the risk profile of the countries in this category.

2.2 The recent deterioration in the macro-economic and socio-political situation of some of the client countries has resulted in increased calls for the Bank, as lender of last resort, to provide adequate response through increased lending in support of the reforms necessary to pave the way to regenerate growth while at the same time ensuring equitable allocation of resources and protecting its balance sheet.

2.3 However, achieving these objectives will remain challenging owing to the specific features of the global and regional operating environments that are summarized below.

VOLATILE OPERATING ENVIRONMENT AND INCREASING VULNERABILITY OF RMC BORROWERS

2.4 The global economic outlook has shifted significantly from August 2011 as a result of the downgrade of the United States by Standard & Poor's from "AAA to "AA+" and the sovereign debt crisis in Europe. Financial markets are going through extreme volatility marked by the widening of sovereign bond spreads of major European countries, declining stock markets and lower growth rates³.

2.5 The Bank's borrowers are not shielded from the spill-over effect of the above developments. Although most of the RMCs' economies were better prepared to face the 2008-2009 financial crisis, they have used the fiscal space that was built up over the past years to alleviate the impact of the previous crisis. Besides, the ongoing turmoil is moving deeper in that wave of downturns is not only affecting financial institutions but also sovereigns in the Eurozone.

2.6 A large number of RMCs are highly dependent on Eurozone countries, making them vulnerable to the economic conditions, particularly in important trading partner countries. The time lag for the transmission of the slowdown in Europe to Africa is estimated at 12 to 18 months. It is expected to have a direct impact on the continent through a lower economic growth and deteriorating external position⁴ as around 40% of Sub-Saharan non-oil exports go to Europe, even though most countries have been diversifying⁵ away from their traditional trading partners.

³ As a result, the expectations for economic growth for 2012 and 2013 have been revised downward with GDP growth for G7 countries expected to reach 1.3% in 2011 and 1.6% in 2012 compared with 2.9% in 2010 (according to most recent IMF figures).

⁴ Economic growth of the continent is expected to reach 4.5% in 2011 and 5.2% in 2012 compared with 5.2% in 2010.

⁵ Diversification trend was toward emerging partners such as China, India and Brazil.

At the same time, lower exports⁶, higher import bills underpinned by high commodities prices, lower foreign direct investments and lower remittances are expected to widen the average current account deficit for African countries to 7.9% in 2011 and 8.1% in 2012 compared with 7.7% in 2010. GDP growth is estimated to be lower than the forecast for the region with higher inflationary pressure than anticipated.

2.7 Ultimately the overall indebtedness of the continent is expected to increase from 38.6% in 2010 to 40.9% in 2011 and 40.6% in 2012⁷ accentuating its vulnerability and calling for the implementation of the necessary reforms to ensure the long term debt sustainability. Additionally, the fluctuations of the euro and dollar have eroded revenues on certain productive exports; put African currencies under pressure with an increase in the risk premium for investors. African private sector borrowers also might experience cash flow pressures and consequently debt servicing difficulties.

2.8 In terms of implication for the Bank's business portfolio growth, future demand is expected to be volatile across regions and across the spectrum of borrowers. Fast disbursing loans is likely to dominate the sovereign demand. However, depending on the pace of the Bank's response to the crisis, volume of new lending may increase or decrease.

Overall, the creditworthiness of some countries in the continent may decline in the future. This has been reflected in several recent rating actions taken by international rating agencies viz some African sovereigns⁸. This shift in creditworthiness will shape the future trends in the Bank's loan portfolio and exposure to credit risk. Accordingly, greater attention ought to be paid to opportunities for diversification through new instrument and enhancement of existing loan products, burden sharing with other development partners and participation in MIGA initiatives for Africa, leveraging on the Bank's resources through credit substitutes and other risk management products are therefore paramount to preserve the Bank's financial integrity and good credit rating.

THREAT OF SYSTEMIC RISK

2.9 It is worth recalling that systemic risk for the Bank will result from correlation between asset classes and among countries in the Bank's portfolio. Concentration in a specific sector or region heightens the exposure to systemic risk. The Bank's public sector portfolio remains concentrated in the North and South African countries which respectively account for 55.4% and 31.6% of total public sector portfolio (outstanding and undisbursed) at the end of September 2011. Such high level of concentration increases the Bank's exposure to the systemic risk of default. Especially among the public sector borrowers with correlated economic growth in the same region. This might be amplified by the ongoing socio-political transitions.

2.10 The financial turmoil and Eurozone stress could result in another threat to the financial sector in Africa although this sector appears not to be strongly linked to the international financial markets. Indeed, linkages are more important in the asset side than on the liability side of the balance sheet. Most banks⁹ in Africa typically fund themselves in the domestic market with limited funding lines from parent/or partner European banks. In addition they strive to keep low foreign liabilities. However, most African countries and banks hold assets in European

⁶ Lessons from the 2008-09 global crises have shown that the most important dimension of the impact on Africa will be through significant reductions in Africa's trade with OECD countries. The Bank has estimated that a decline of 1% in the economic growth of OECD countries is estimated to result in a decline of African exports by 10%.

⁷ According to the IMF World Economic Outlook dated Sept. 2011.

⁸ Following the socio-political unrests this year, Tunisia's and Egypt's ratings have been downgraded from BBB and BB+ respectively to BBB- and B+. South Africa's rating has been placed on negative outlook signaling the possibility of a downgrade in the next twelve months.

⁹ With the exception of South Africa, and Nigeria to a certain extent.

partners' banks¹⁰. The Eurozone links are tighter with West and Central Africa, particularly the francophone countries. Furthermore, there is the growing financial presence in the region by Pan African Financial Groups (UBA, Ecobank, Atlantic Bank, Stanbic, Bank of Africa, etc.). Some of these financial groups operate without full consolidation and cross-border supervision, hence they could be the sources for systemic and contagion risks.

Overall, there is an increase in systemic risk in the Bank's portfolio that impacts will depend on: (i) the ability of RMCs to restore the fiscal buffers required to cope with the spill-over effects of the global economic downturn, and (ii) the adequacy of regulatory capital buffers of the banking systems. The risks to ADB are not marginal as compared to the previous financial crisis and need to be closely monitored. Some countries are more at risk than others and the Bank's exposure to their financial sector needs to be carefully and continuously reviewed.

CHALLENGES OF FULFILLING THE BANK'S DEVELOPMENT MANDATE AND TAKING ADDITIONAL EXPOSURE TO STRESSED COUNTRIES

2.11 The Bank has recently been called upon by the international community in general and G20 in particular to take on additional exposure in African countries facing socio-political turmoil in order to support them to achieve inclusive growth. Notably, the Bank has been requested to coordinate and lead over the next year the development assistance activities of lenders in North Africa. The deteriorating creditworthiness of borrowing countries would lead to even increased demand for development financing assistance.

2.12 Scaling up the Bank's intervention in these countries is clearly necessary not only because of its development mandate but also because most of these countries have been active and reliable borrowers of the Bank, supporting its portfolio growth in the past. However, high portfolio concentration, increased systemic and contagion risks as well as the challenges these countries face in terms of rating are expected to put additional pressure on the Bank's risk bearing capacity.

Consequently, it is critical for the Bank to carefully manage the growth and distribution of its development related exposure across regions, countries and sectors. Additional exposure to stressed countries should be commensurate with the Bank's capital position. Additionally leveraging and risk mitigation should be implemented to protect the Bank against unexpected portfolio deterioration.

LIMITED PORTFOLIO DIVERSIFICATION POSSIBILITIES AND MARKET CONSTRAINTS ON HEDGING OPPORTUNITIES

2.13 With a declining appetite for the Bank's lending products from investment grade countries in non-stressed regions since 2009, there is little room for diversification within the sovereign portfolio. This constraint is exacerbated by the credit policy, which limits sovereign lending to 17 out of the 54 RMCs. Moreover the lack of fungibility of risk capital between the sovereign and non-sovereign windows¹¹ for ADB countries and between the different African regions¹² is reducing opportunities for diversification.

¹⁰ As per BIS report published in October 2011: "Detailed tables on preliminary locational and consolidated banking statistics at end-June 2011".

¹¹ This can be achieved through shifting the unutilized capital from one window to cover the excess capital consumption of the other window.

¹² This means the transfer of the unutilized capital from inactive regions to the most active regions while remaining within risk appetite and country limits.

2.14 Although the recent growth in non-sovereign guaranteed loans has contributed to a reduction of the concentration in the Bank's Development Related Exposure (DRE), the diversification impact is limited by the lack of a strong pipeline of large scale and good quality projects, particularly in countries and regions underrepresented in the portfolio. Furthermore, the time taken for the pipeline to translate into approvals and disbursements will not allow for sufficient portfolio build-up to offset the increase in exposure to stressed countries in the coming years

2.15 Moreover, the availability of low cost hedging instruments is reduced¹³. Implementing structured transactions aimed at protecting the Bank from the adverse impacts of the default of large borrowers is no longer viable from a commercial perspective because of the sharp decline in international banks' risk appetite for these types of transactions and the necessity of preserving their capital amid stressed market conditions and higher regulatory constraints¹⁴.

While the Bank shall continue to operate within the spirit of the 1995 credit policy, it is necessary to widen the scope of enclave policy (e.g. to sub-sovereigns and large regional PPP) and address specific needs of ADF green light countries with good prospects of greater absorptive capacity. Shift in the operational environment calls for a review of the credit policy, not necessarily for fundamental changes¹⁵, but to unlock additional diversification opportunities and reduce there by concentration risk..

The growing systemic and contagion risk also implies that the Bank shall continue to prospect the market for the right opportunity to implement hedging solutions in order to free-up additional resources for the most active RMCs while reducing the portfolio's concentration.

III- RECENT DEVELOPMENTS IN THE BANK'S PORTFOLIO RISK ASSESSMENT

SHIFTS IN EMPHASIS OF RISK ASSESSMENT METHODOLOGIES TO COPE WITH THE VOLATILE ENVIRONMENT

3.1 In contrast to benign credit cycles in the past, the recent financial turmoil has revealed the failure of the industry's risk models and limited ability to measure "tail-end¹⁶" risks. Valuation and systemic risk measurement challenges emerged. Simple estimates such as "how much a fall in real asset value can be attributed to a particular market determinant" are no longer straightforward. Risk bucketing¹⁷ approach showed limitation in terms of providing adequate assessment of capital/risk coverage. Fragmented management information on the degree of risk facing organizations and lack of internal transparency relating to transactions data imply difficulty in taking timely decisions.

3.2 As a result, additional emphasis has been placed on forward-looking stress tests and scenario analysis, and risk management systems are being improved to cater for the new shift in paradigm. It becomes also imperative to enhance collateral valuation models and develop a better understanding of new products risk impact and management. In this regard, most of the financial

¹³ Hedging costs are increasing significantly with the current market turmoil

¹⁴ Such as the implementation of Basel III which will increase the capital requirements for commercial banks.

¹⁵ The spirit of the credit policy to grant non-concessional loans only to creditworthy countries is a basic risk management principle and should be retained.

¹⁶ Extreme risks that occur with a very low probability but which effects are very strong.

¹⁷ Defined as assets having similar risk.

institutions are adjusting their risk tools and strengthening their risk infrastructure. In terms of models' recalibration and adjustment, MDBs in particular face more challenges given the unique features of their business model. Nevertheless, they have already undertaken significant IT enhancement projects to address these challenges.

3.3 In this regard, **the Bank has over the last several months, reviewed the functioning of its risk management framework and risk measurement approaches.** It has introduced a number of measures aimed at: (i) advancing its approaches (for equity and structured product models), and (ii) developing early warning and detective alert systems to quickly recognize, evaluate and mitigate gradual build-up of impaired assets and signs of systemic risk.

Significant strides have been made in 2011 in strengthening the Bank's risk management tools and instruments but a lot remains to be done. Future directions in enhancing risk measurement and mitigation tools are decentralization of the use of these tools to three layers of risk management within the institution: (i) front-line risk management – to allow risk takers to assess primary risk and be held accountable for quality at entry of transactions in the portfolio; (ii) core risk management – to provide a more holistic view of the aggregated risk at portfolio and balance sheet levels and guide portfolio balancing and risk mitigation decisions of the Credit Risk Committee under implementation; and (iii) internal and external audits through buildup of controls and check points that will allow them to assess the adequacy of risk measurement procedures and their consistency with best practices.

SHIFT IN EMPHASIS OF RATING AGENCIES

3.4 **Rating agencies have also significantly improved their methodologies with wider disclosure.** Another major change relates to the shift in their focus from the callable capital and adequacy of capital buffer, whose effective value is being questioned, to the quality of the portfolio of DRE. The rating agencies have been focusing mainly on the narrow risk bearing capacity (i.e. the Bank's immediate available equity resources) as well as correlations/systemic risks. Therefore any deterioration in the creditworthiness of the largest borrowers of an MDB or single name can translate into a negative rating signal. They are also requesting MDBs to strengthen significantly their capacity to monitor and manage the risks related to their DREs and treasury operations.

3.5 **In the case of the Bank, issues related to portfolio concentration are being raised. Such concerns are particularly heightened by the recent downgrades** of some major regional member countries notably in North Africa. Indeed, although the Bank has significantly reinforced its credit risk management processes and tools, concentration risk remains unmitigated and needs to be addressed through a combination of risk management measures (e.g. new hedging avenues) and operational measures (selectivity and good pipeline development).

3.6 Finally, several European countries, the United States as well as several large banks in those countries have been downgraded by various rating agencies in 2011. Rating pressure is expected to remain in the near term. These are expected to have an impact on the Bank and Africa.

It is therefore imperative for the Bank to adjust its capital allocation framework¹⁸ and to continue dialoguing with bondholders and international rating agencies to alleviate their concerns and provide assurance that portfolio related risks are adequately mitigated.

¹⁸ Regular update of some parameters is necessary on an annual basis.

AUDITORS CONCERNS ABOUT THE CREDIT MIGRATION OF THE PORTFOLIO

3.7 The issues surrounding credit risk are also relevant to the application of international standards such as IFRS or GAAP. It is worth noting that during the last audit exercise, the Bank's external auditors highlighted the need for prompt corrective actions of the risk ratings in the context of rapidly changing risk environment.

Several actions have been implemented to improve the timeliness of rating actions for countries and non-sovereign transactions.

The reinforcement of processes and portfolio management practices also become more relevant for external auditors to adjust the risk profile of the loan portfolio to unexpected and rapid shift conditions of our sovereign and non-sovereign borrowers.

IV- PORTFOLIO QUALITY AND RISK PROFILE

PORTFOLIO DYNAMICS

4.1 The key drivers of the Bank's balance sheet growth and risk profile are the approval rates, pace of disbursements, type of lending instruments used, the risk ratings of the transactions and cancellations. The analysis of the dynamics and the evolution of these key determinants are crucial for the assessment of the future risk profile of the portfolios (public and private sector). This allows also for the identification of negative trends and the implementation of corrective measures to ensure sound portfolio growth (in volume and quality) and effective utilization of the Bank's financial capacity.

Table 01: Key Portfolio Dynamic Indicators

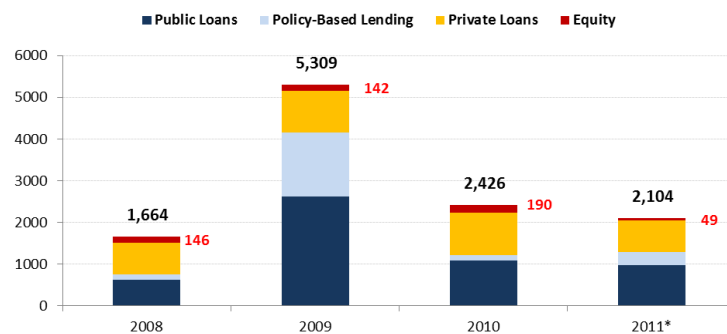
		2008	2009	2010	3Q2011	
Key Drivers	Approvals (UA million)	1,665	5,309	2,426	2,105	▼
	Share of Private Sector	54%	22%	50%	39%	▼
	Share of PBL	8%	29%	5%	15%	▲
	Disbursements	729	2,352	1,340	1,249	▼
Portfolio Growth	Outstanding DRE* (UA billion)	5.9	7.6	8.6	9.2	▲
	Sovereign Portfolio Growth	3%	16%	9%	8%	▼
	Non-Sovereign Portfolio Growth	52%	124%	15%	0.20%	▼
Structural Changes in the Portfolio	Share of Non-Sovereign Loan	10%	19%	20%	17%	▼
	Share of Non-Sovereign Loan & Equity	12%	21%	22%	21%	▼
	Regional Concentration (North Region)	55%	49%	47%	47%	►

*Development Related Exposures

4.2 Approvals continue to remain below 2008/09 crisis levels and below the annual sustainable lending level with significant volatility in the Indicative Operational Pipeline (IOP). In 2011, the private sector approval volume was almost at par with the public sector and such trend may continue for project lending (i.e. excluding public sector budget support loans).

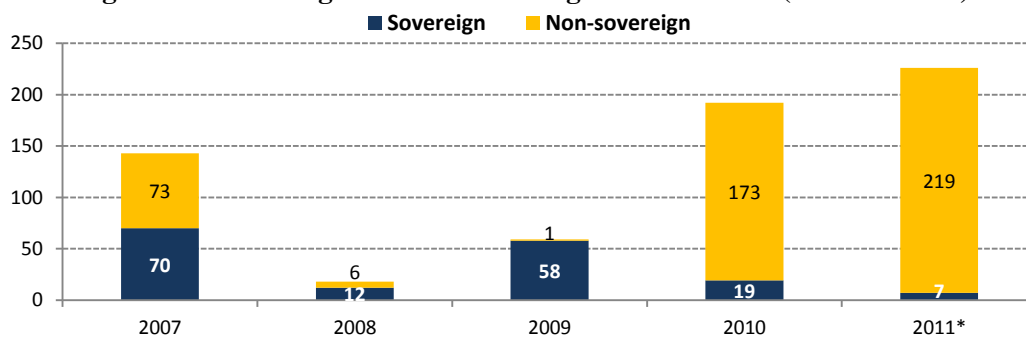
4.3 An emerging trend in the portfolio is the increasing share of equity participations and private equity funds in the annual private sector commitment. The rationale behind such increase is that these investments play catalytic roles in financing development projects in Africa and provide seed funds to attract other investors to contribute to the development of SMEs and microfinance operations on the continent. Carrying out this mandate however, may result in an increase in the share of high risk assets in the portfolio and an upward shift in the WARR and RCUR if the risk embedded in these instruments is not mitigated.

Figure 01 – Approvals by main type of instrument (in UA million)



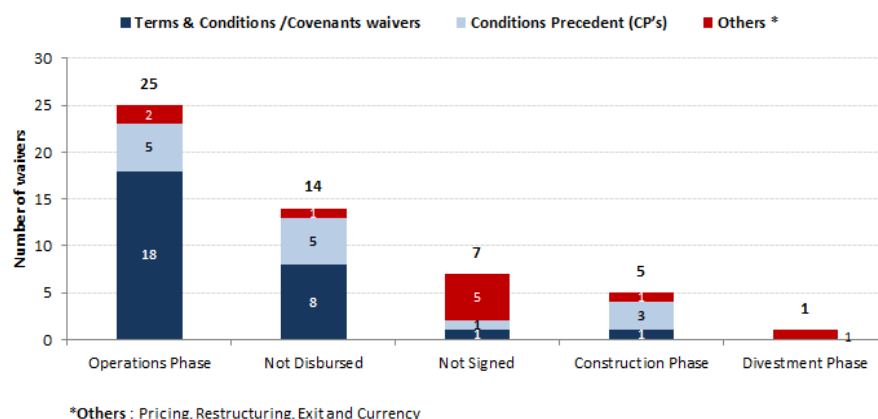
4.4 Slow pace of disbursement and an increase in loan cancellations- The pace of disbursements is below expectation and if the trend continues, portfolio growth could be slower than originally projected. Loan cancellations have significantly increased over the last two years, reaching a cumulative amount of UA 638 million at 30th September 2011. Private sector cancellations for the year to September 2011 are particularly high, due to the cancellation of the Tenke Fungurume project in DRC (UA 65 million) and the Guinea Aluminum project in Guinea (UA 130 million).

Figure 02 – Sovereign and Non-Sovereign Cancellations (in UA million)



4.5 Increasing number of waiver requests is another development in the private sector portfolio, which may be indicative of insufficient quality and project readiness at entry into the portfolio. Typically, waiver requests have related to changes or amendments to conditions precedent, terms and conditions, pricing or covenants, that deviate from the initial agreements made at origination of the project. From the period 01/03/2010 to 30/06/2011, 52 waiver requests were submitted

Figure 03– Waiver Requests by Project Status



to the OPSMRC¹⁹ as illustrated by Figure 03²⁰.

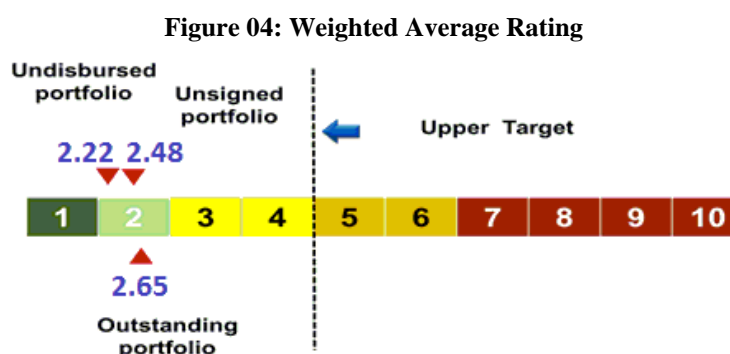
It is therefore important that attention is given to deal structuring, pricing indications and the reasonableness of CP's during the Project Appraisal Process, so as to keep the number of waiver requests at a minimum and improve disbursement ratios. This endeavor should be the joint responsibility of OPSM, GECL and FFMA.

PORTFOLIO QUALITY

4.7 Portfolio quality is measured through a set of metrics among which are (i) the weighted average risk rating (WARR), (ii) share of moderate and low risk classes, (iii) concentration indices; and (iv) vintage analysis of migrations and workouts.

Weighted Average Risk Rating (WARR)

4.8 With a WARR²¹ of 2.65 as of September 2011, the Bank's overall portfolio quality can be considered as sound. Indeed although the WARR has increased compared to 2.25 at the beginning of the year end, it remains below the target range of 3-4. Figure 04 shows the projected distribution of the Sovereign and Non-Sovereign loan portfolios by WARR when grouped in the following processing stages: (i) outstanding portfolio as of 30th September 2011 (ii) signed but undisbursed commitments; and (iii) approved but unsigned operations. Despite the lower WARR on the unsigned and undisbursed portfolio, a further deterioration of the WARR is expected as a result of likely downgrades both in the sovereign and non-sovereign portfolios. In 4Q 2011 a number of adverse ratings actions have been instituted, notably a two notch downgrade on Egypt, a downgrade on Rascom from 7 to 9 and downgrades on three private equity funds.



The good WARR level is essentially driven by the share of creditworthy and investment grade countries in the portfolio. Migrations in this segment of the portfolio will yield to a deterioration of the WARR. Therefore, there is the need to ensure quality at entry of the transaction in the portfolio irrespective of the fact that it is sovereign or non-sovereign lending. The North Africa Portfolio should be closely monitored.

Share of High and Very High Risk in the Portfolio

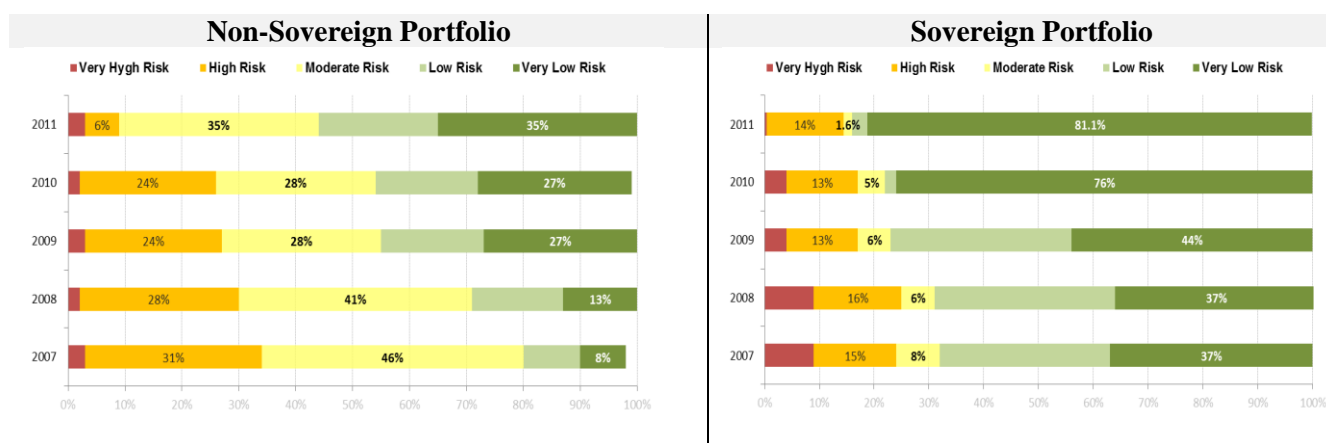
¹⁹ Under the current procedures, waiver requests issued by the Project Sponsors or obligors are submitted to the OPSM Review Committee (OPSMRC) for the approval of its members: GECL, OPSM, OIVP, FFCO, FTRY and FFMA. GECL is the department determining if a waiver request should be presented to the OPSMRC, depending on whether the request has a financial impact and is in line with the authorities provided for in the OPSMRC TOR.

²⁰ A detailed report on waivers is being finalized for ALCO monitoring.

²¹ WARR is defined as the average of the sum of the product of the rating and the outstanding amounts in the portfolio

4.9 As indicated by Figure 05, more than three quarters of the Bank's public sector outstanding portfolio is in the Low and Very Low risk classes despite the recent downgrade of Egypt and Tunisia. This is due to the impact of the Bank's credit policy and the almost near to full disbursement of large loans granted to South Africa, Botswana and Mauritius. The share of High and very High risk in that sovereign portfolio is made up of loans granted before the adoption of the credit policy when all RMCs were eligible to borrow from the ADB window. It is expected to decrease with the amortization of these old loans. The increasing share of Very High risk in the non-sovereign portfolio reflects the risk appetite of the Bank and the need to be relevant to LICs and FS. It however requires careful monitoring and adequate balance between ADOA and risk, with credit risk as primary determinant for entry of transaction in the portfolio.

Figure 05 – Distribution of the sovereign and non-sovereign portfolios by risk classes



Further migration from moderate to high and very high risk in the portfolio is not desirable particularly in the non-sovereign window. In this respect, it is important to note that a large share of the private sector portfolio is immature (less than 4 years old) and some of it is still within the grace period. As the portfolio ages, there are likely to be rating migrations that could affect the quality of the portfolio. This underscores the need for strengthening portfolio management and good collateral management.

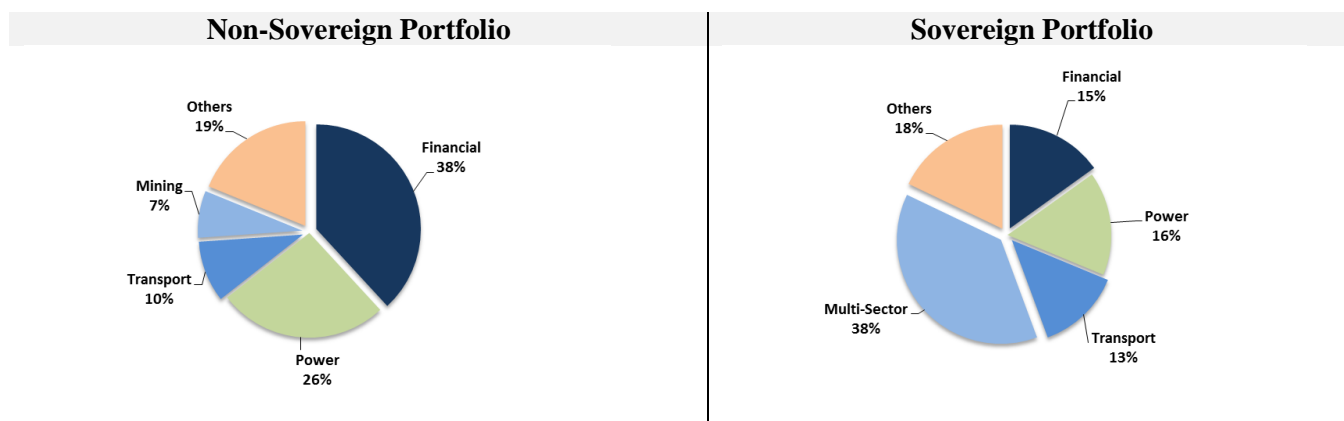
Concentration Risk Profile

4.10 Like all regional MDBs, the Bank faces the constraint of a more concentrated portfolio structure due to the narrow client base and exposure management policies that limit their degree of potential portfolio diversification.

4.11 **The sector concentration profile** is different in the private sector portfolio compared to the public sector portfolio. The common thread however is that, the financial sector dominates both portfolios in terms of sector concentration, as shown in Figure 06, making the portfolio sensitive to systemic risk. Almost 37.7% of the public sector portfolio as of September 2011 is concentrated in the Multi-sector category which comprises public sector management, including structural adjustment programs and debt relief operations, governance and anticorruption programs, industrial import facilitation, export promotion, and institutional support. Power sector was second largest in the sovereign portfolio representing 16.2% of the total portfolio as of September 2011 and closely followed by the financial sector which accounted for 15.1% of the total portfolio at the same date. This distribution has remained fairly stable over the past three years. For the Non-Sovereign analysis we limit the segmentation of the private sector to five broad sectors: Financial Services; Power; Mining and other industries (including manufacturing projects); Transport; and other remaining sectors. The Financial Services sector, through Lines of

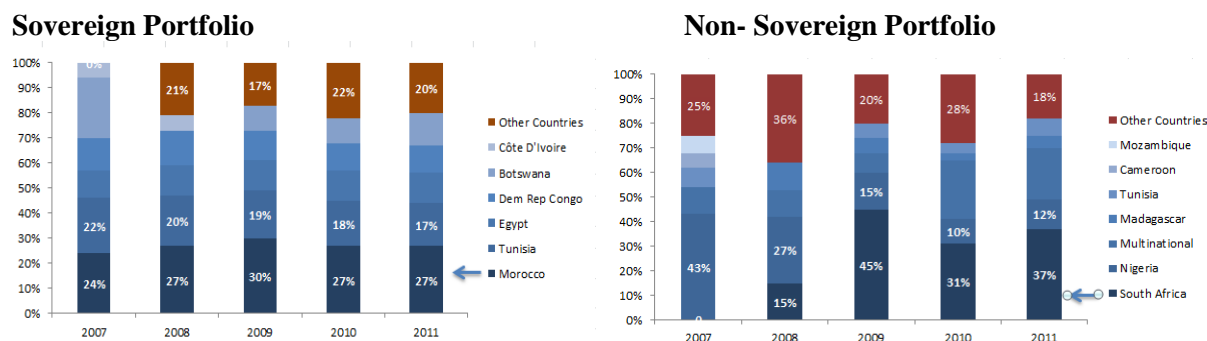
Credit to Financial Institution (FIs), was the largest sector accounting for 38% of the Outstanding Portfolio as of September 2011.

Figure 06 – Distribution of the sovereign and non-sovereign portfolios by sectors



4.12 **Regional concentration in the portfolio** is high and represents a major source of vulnerability for the Bank. The North African region still dominates the portfolio, constituting 45% of the overall portfolio. However the portion of the portfolio in the Southern African region is growing steadily (more than doubled in 2009 and stood at 26% in 2010 and at 29% as of September 2011). While South Africa represents the largest exposure in the Non-Sovereign portfolio (37%), Morocco is the largest borrower in the Sovereign portfolio (with 27% share) at end of September 2011 as presented in Figure 07.

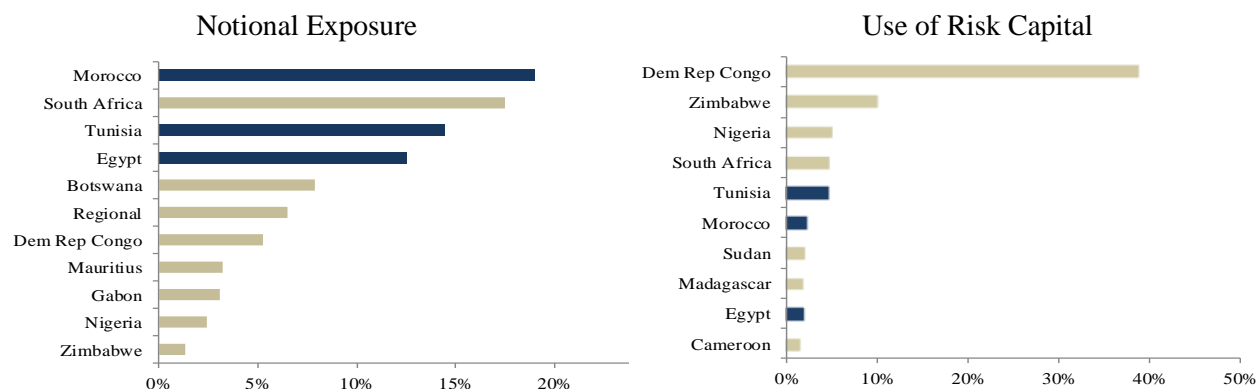
Figure 07 – Distribution of the sovereign and non-sovereign portfolios by 5 largest borrowers by countries



4.13 The outstanding exposure to Morocco accounted for approximately 38% of the Bank's equity at end-2010, and the outstanding five largest exposures (i.e. Morocco, Tunisia, Egypt, DRC and Botswana) represented 109% of equity in nominal terms, which compares favorably with other MDBs, as pointed out by the rating agency Fitch. This ratio has been increasing in 2011, as a result of the increase in the Bank's exposure to North Africa reaching 118.4% at September 30, 2011. Taking into account the undisbursed exposures will propel this ratio to 186.7% at the same date.

It is important to note that the comparison of the Notional and Risk Weighted Exposures of the Bank's portfolio shows that although the North African countries, Morocco, Tunisia and Egypt accounted for 45% of the notional exposure they hold only 9% of the risk-weighted exposure per June 2011 as shown by Figure 08

Figure 08 – Notional Exposure versus Use of Risk Capital of 10 largest borrowers



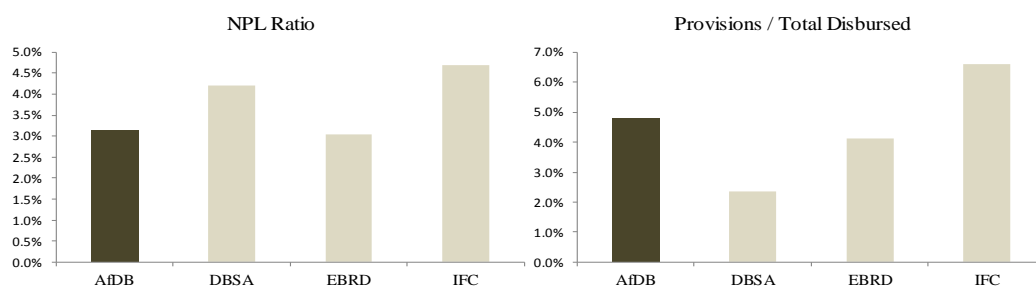
4.14 The Bank's Non-Sovereign exposure to South Africa and Nigeria, measured in terms of outstanding amounts, increased respectively from 31% in 2010 to 37% and from 10% in 2010 to 12% due to changes in the overall private sector portfolio composition. However it can be anticipated that the exposure to South Africa will grow due to the approval of facilities for DBSA and the Kalagadi Mining Project in 2011.

Non-Performing Loans

4.15 Impairment provisions for both the impaired principal and the charges amount to 4.8% of the aggregate outstanding balance of the sovereign and non-sovereign portfolio. Annex 2 presents the loan impairments for both the sovereign and the non-sovereign exposures.

The non-performing loan ratio and loan impairment provisions compare well with those of other development institutions. Both the EBRD and the IFC noticed increases in their non-performing loans in the aftermath of the financial crisis, DBSA showed an improvement over the past two years, while the Bank's non-performing loans remained fairly stable.

Figure 09 – Comparative NPL ratio and Provisions to Total Disbursements



However as previously stated, the non-sovereign portfolio is relatively young and therefore the risk of increased impairments as the portfolio matures is non-negligible. Therefore it is imperative that risk appetite is closely monitored and continuously reevaluated.

4.16 We have presented the distribution of portfolio risk as measured by the WARR, concentration risk and a comparative analysis of non-performing loans and provisioning based on incurred losses. The expected loss is an alternative measure to quantify portfolio risk and is obtained by taking into account the occurrence of a default event (Probability of Default) and the portion of the loan that can be recovered (Loss Given Default) ²². The measurement of the

²² Expected Loss = Probability of Default x Loss Given Default x Exposure at Default

expected loss is a requirement for the Basel II Advanced Internal Ratings Based Approach and is also considered under the new accounting standard for Financial Instruments - IFRS 9, which is expected to become effective in 2015.

For the sovereign portfolio the actual risk is associated with the high risk class and consists mainly of the exposures to DRC and Zimbabwe. Despite the high nominal exposure (measured by outstanding amount) to mainly Morocco and South Africa in the “very low risk” and “low risk” classes, the expected loss amounts to UA 1.3 million in these two classes.

For the non-sovereign portfolio it shows the highest expected loss for the “very high risk” class, which consists of exposures in default that are all adequately provisioned. The provision was not taken into account in the expected loss calculation. About 50% of the expected loss is located in the “high” and “very high” risk classes.

V- POTENTIAL PORTFOLIO THREATS AND RISKS

MEDIUM TERM PORTFOLIO OUTLOOK

5.1 The Bank plans to lend around UA 3.6²³ billion per year from 2012 to 2015 under the baseline scenario which is the same as that of GCI-VI. This scenario assumes an average portfolio risk rating of 3 to 4 with sovereign lending accounting for 63% of the total annual approval. This should lead to an outstanding portfolio (including equity participations) of UA 17.1 billion in 2015 from UA 8.6 billion at the beginning of 2011. The non-sovereign portfolio should continue its steady growth by doubling over the next 3 years while its share of total DRE is expected to reach 28% in 2015 compared to 22% in 2011. Table 02 provides the DRE portfolio in terms of projected disbursed and outstanding balances. It shows the significant anticipated growth of equity investment portfolio.

Table 02: Projected Disbursed and Outstanding Portfolio (in UA Million)

OUTSTANDING	2010	2011	2012	2013	2014	2015
Sovereign Loans	6,673	7,664	8,447	9,672	11,192	12,392
Non-Sovereign	1,892	2,195	2,775	3,410	4,154	4,722
Private Loans	1,620	1,857	2,308	2,815	3,401	3,799
Equity	272	338	466	595	754	923
Total Loans	8,293	9,521	10,755	12,486	14,593	16,191
Total	8,565	9,860	11,222	13,082	15,347	17,114

Medium Term Profile of the Bank’s portfolio is in line with risk appetite forecast in terms of share of private sector portfolio growth. If there is no further deterioration in the existing portfolio (especially in the public sector i.e. further downgrades), the portfolio risk profile should remain good with a WARR within the target range of 3-4. The increasing share of riskier equity investments, although in line with the Bank’ mandate should be carefully monitored and gradual exits should be contemplated whenever possible.

²³ The Bank could lend above this indicative volume if its internal resource generation capacity increases or the risk profile of the overall portfolio improves.

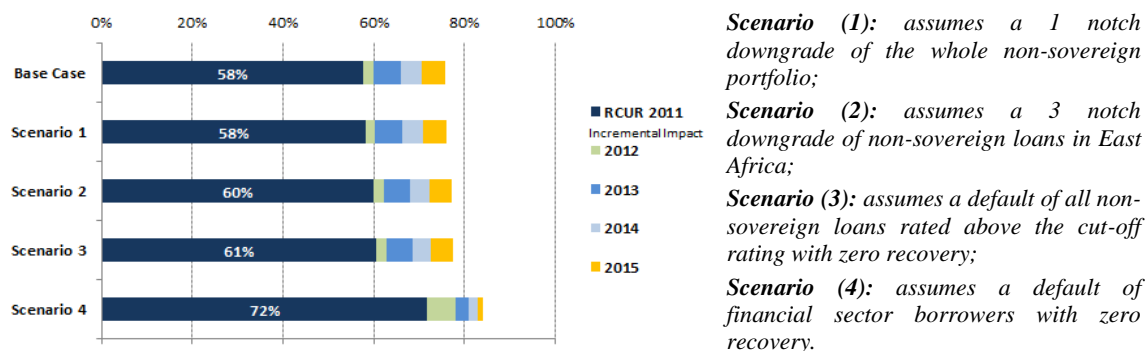
POTENTIAL PORTFOLIO THREATS AND RISKS

Non Sovereign Loans Credit Migration

5.2 The main source of risk in the Bank's portfolio stems from the potential negative credit migrations. Indeed given the young nature of the non-sovereign portfolio, its quality is still difficult to assess and is expected to be volatile in the coming years. Without sufficient historical data on defaults, transition matrices and rating migrations, proxies with reasonable assumptions are being used to stress test the portfolio in order to better evaluate its credit risk. The stress testing factors in key parameters such as: (i) projects in countries facing socio-political transitions or economic difficulties (North Africa, Fragile States, etc.); (ii) projects recently downgraded or under watch-list; (iii) sectors under stress or with systemic risk (financial sector in some exposed countries); and (iv) projects rated above the cut-off rating of 5. Figure 10 shows the impact of four stress scenarios on the Risk Capital Utilization Rate (RCUR). These tests show that RCUR will not exceed 77%, except when the portfolio is subjected to the extreme events as summarized in scenario 4 where the RCUR would reach 84% by 2015. This underscores the adequacy of the financial cushion of the Bank.

Although the Bank still has enough cushion to support credit migration in the currently young private sector portfolio, it needs to build resilience through adequate transfer of income to reserve, ensure good collateralization and strong guarantees at entry of new transactions in the portfolio, and enhanced supervision of existing private sector portfolio. Moreover investment officers should be held accountable for credit quality of transactions through the establishment of deal sheet similar to the IFC.

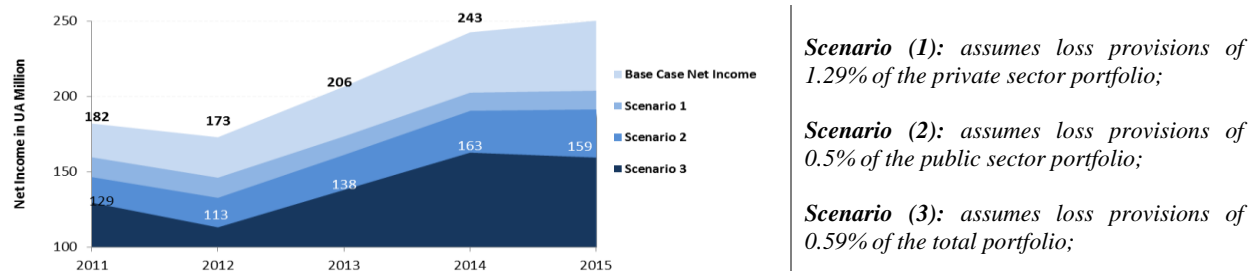
Figure 10 – Sensitivity to non-sovereign credit migration (2011-2015)



Significant Portfolio Impairment

5.3 In the event that credit migrations result in impairments, the Bank's projected net income would be significantly reduced. To show the potential impact, Figure 11 presents the impact of three scenarios using historical level of provisioning in percentage of outstanding portfolio as baseline.

Figure 11 – Sensitivity to increased level of provisioning (2011 – 2015)



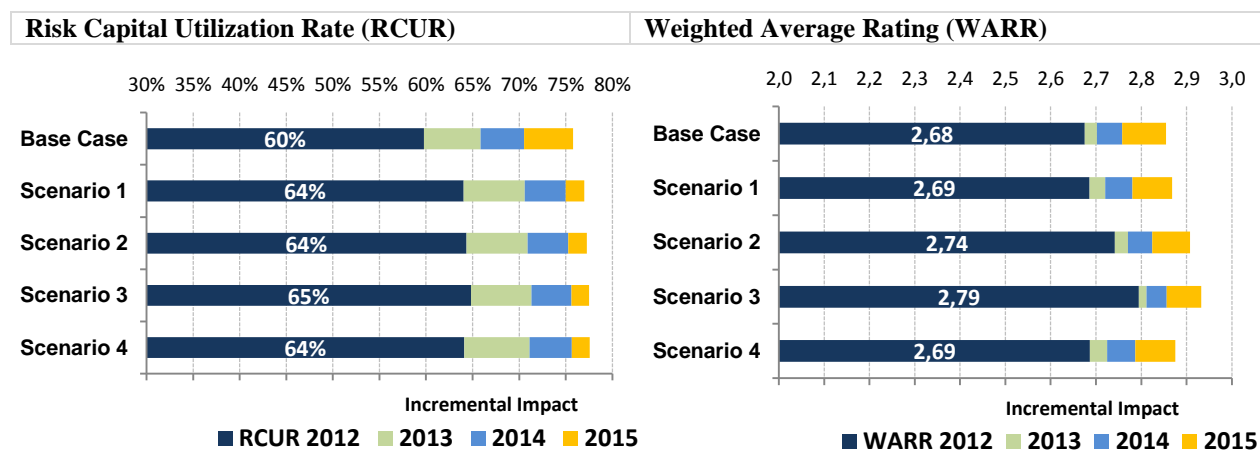
Increased Fast Disbursing Operations to Stressed RMCs

5.4 In view of the ongoing stress on some RMCs, and in particular North African countries, the Bank as premier development institution, has to provide an adequate response that also meets the needs and expectations of these countries. Given that most of these countries do not have enough fiscal headroom or flexibility and that their external situation could further deteriorate with the ongoing turbulence in Eurozone markets, they tend to prefer budget support and fast disbursing operations. Indeed although the Bank often responds favorably, these types of operations could put further pressure on the Bank's prudential ratios and increase further the regional concentration risk in the portfolio, if they are not offset by project lending to creditworthy entities/countries in other regions.

5.5 Figure 12 shows that additional annual lending of UA 1.4 billion from 2012 to 2014 to three stressed countries, through front loading of their SLL, using fast disbursing instruments would increase the Bank's outstanding portfolio by UA 1.8 billion leading to a RCUR of 78% in 2015. Although the cumulative increase in RCUR is only around 2% by 2015 compared to the base case, the immediate impact in 2012 and 2013 is much greater and could put pressure on the Bank's commitment capacity if combined with portfolio quality deterioration.

In approving lending proposals for stressed countries in Africa, the Bank needs to ensure adequate balance between: (i) the objective of providing adequate resources to a reliable client in implementing the reforms needed to ensure sustained growth, and (ii) the imperative requirement to contain the high and growing concentration risk. In this regard, a programmatic approach should be followed. This approach consists in structuring a 3 year program based envelope in several tranches associated with each reform package in which the Bank is called upon to intervene. It also entails that the sum of the multi-tranches (a tranche for each year) should not be more than the cumulative annual sustainable lending to the country over the planning horizon.

Figure 12 – Sensitivity to increased lending in 2012 and 2014



Scenario (1): assumes UA 1.4 billion of fast disbursing PBLs to North Africa every year from 2012 to 2014;

Scenario (2): assumes Scenario (1) combined with a one notch downgrade of Morocco;

Scenario (3): assumes Scenario (1) combined with simultaneous downgrade of Morocco and Tunisia by 1 notch;

Scenario (4): assumes Scenario (1) with an increase of PSO from an average of UA1.2 billion to UA 1.4billion over 2012-2014.

SYSTEMIC AND CONTAGION RISKS

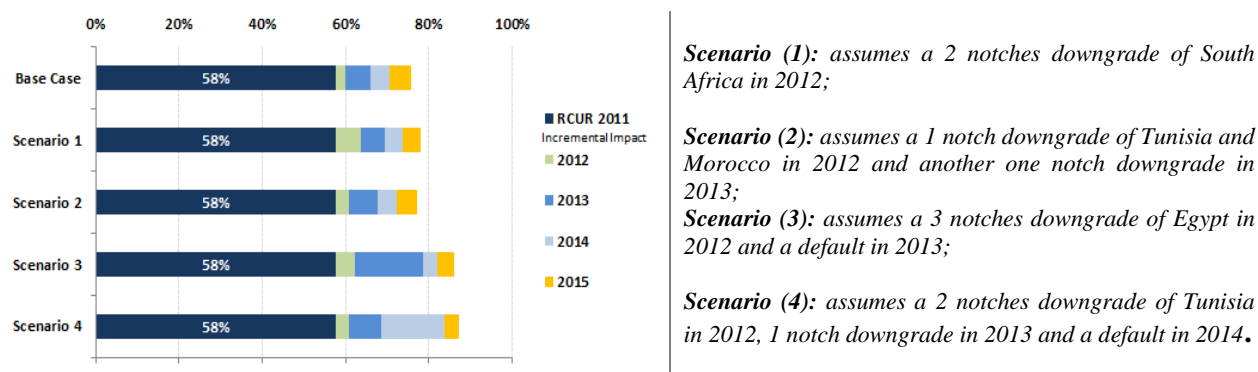
5.6 With the ongoing financial market turbulence affecting not only the financial institutions but also governments and sovereign entities, systemic risk becomes an important component of risk universe. For the Bank, systemic risk has several dimensions among which: (i) systemic risk

associated with high concentration risk and exposure to African stressed countries; and (ii) Financial sector contagion risk.

Impact of Potential Downturns²⁴

5.7 Most of African Countries with high absorptive capacity and good credit standing (before the recent downgrade) and to which the Bank has high exposure remain vulnerable to swings in demand in Eurozone as main trading partners and export market. Their future growth prospects and creditworthiness depend on recovery in demand. Prospects to maintain a strong credit rating depends on the outcome of policy actions to enhance resilience²⁵ and ensure successful socio-political transitions. If these conditions do not materialize, and the country records further deterioration of ratings (e.g. new downgrades), the impact on the Bank's portfolio quality could be significant. Figure 13 shows the impact of different scenarios of deterioration in North and South Africa including a high correlation with the credit quality of some of the private sector projects located in these jurisdictions.

Figure 13 – Sensitivity to Systemic and Concentration Risk (2011 – 2015)



Over the Medium Term Horizon, the Bank has the capacity to withstand the most stressed shock. Indeed, the RCUR would remain below 100% in most of the stress scenarios. However a default of at least one of the largest exposure would push RCUR above 85% by 2015 and reduce significantly the Bank's future commitment capacity, but will not constrain its capacity to continue fulfilling its development mission.

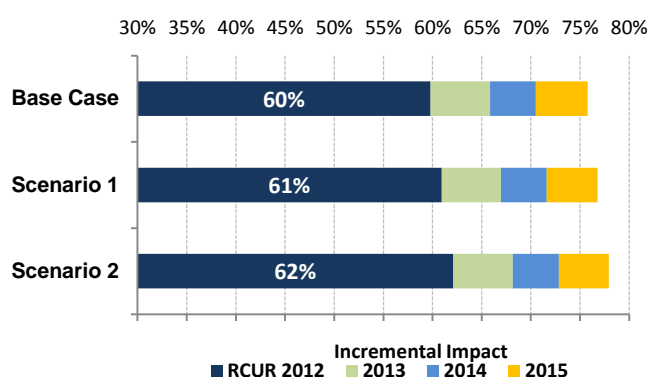
Financial Contagion Risk

5.8 Unlike the previous financial crisis, the ongoing financial market turmoil may have some spill-over effects on the financial sector of the RMCs. This will be mainly through: (i) the asset of local banks' balance sheet, and (ii) through contagion of Pan African financial groups operating in the absence of consolidated supervision. These developments will have implications for the Bank's future portfolio risk profile. Assuming that some of the financial institutions to which the Bank has exposure to, are downgraded with cascading effects on other banks in which they have shareholdings, the impact on ADB will not be marginal as illustrated by Figure 14.

²⁴ As result of economic shock and contagion risk emerging from socio-political tensions in the region

²⁵ For instance, create fiscal headroom and buffers to cope with a deepening of the crisis

Figure 14 – Sensitivity to Financial Contagion Risk (2011 – 2015)



Scenario (1): assumes a 1 notch downgrade of pan-african banks including regional institutions;

Scenario (2): assumes a 2 notches downgrade of Pan-African banks including regional institutions and one notch of all other banks;

VI- RISK MONITORING AND MITIGATION

6.1 In the previous section, Management has highlighted measures required to address specific credit risk issues and in particular the emerging threats to sound portfolio growth and the potential stress on portfolio quality.

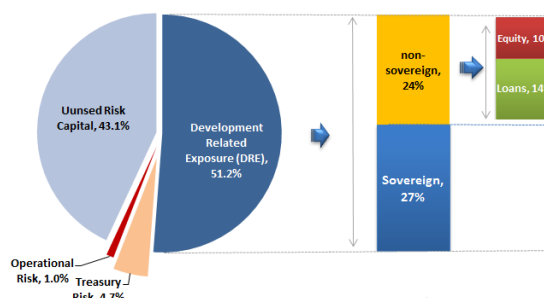
6.2 To build resilience and to prepare the Bank for the continuing growth in non-sovereign operations and also to factor new developments in the Bank's operating environment, different initiatives are ongoing to scale up the credit risk management capabilities, strengthen risk management oversight and governance. The Bank has increased resources in terms of systems and policies to meet these challenges on the business side (the 'risk takers') and those responsible for managing risks (the 'risk managers').

PORTFOLIO RISK MONITORING AND COMPLIANCE

Compliance with Risk Appetite and Prudential Limits

6.3 In the risk appetite statement of the Bank 90% of the risk capital of the Bank is allocated to core risks (DRE Portfolio in the proportion of 45% for sovereign and 45% for non-sovereign) and 10% to other risks (market risk and operational). As at end September 2011, DRE used 51% of the total risk capital of the Bank of which: 27.1%²⁶ and 24.1% for sovereign and non-sovereign respectively against their target of 45% each. This provides assurance that there is sufficient headroom available to absorb adverse rating migrations and pursue lending activities.

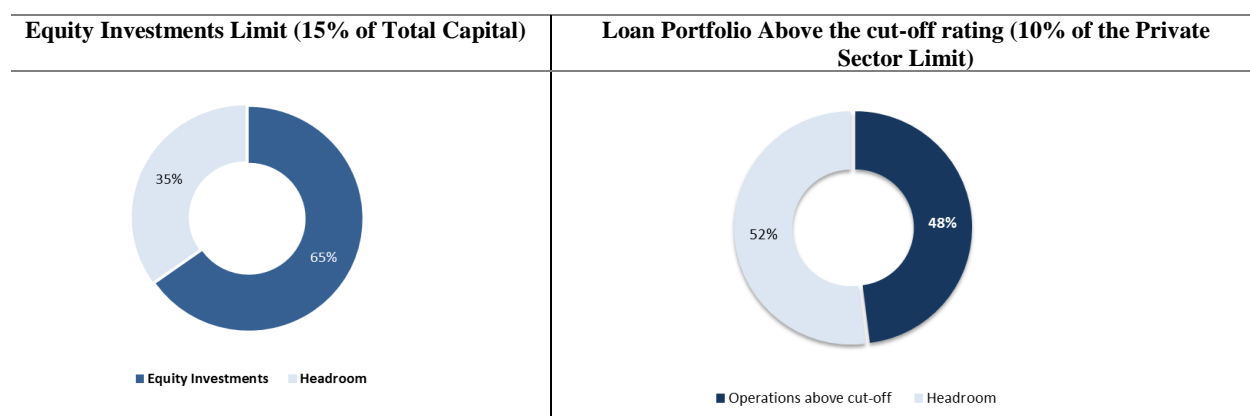
Figure 15: Risk Capital Utilization versus Risk Appetite



6.4 In addition to the statutory requirement that limits equity investments to 15% of the risk capital of the Bank, the risk appetite statement of the Bank also caps transactions above the cut-off rating to 10% of the risk capital allocated to private sector. Figure 16 shows that none of these limits have been breached. Indeed, as of September 2011, the combined exposures for equity investments and loans above the cut-off results in a utilization of the Risk Capital of the Bank of around 11%, out of the 20% available.

²⁶ RCUR for sovereign operations is set to increase further because of rating downgrade of some RMCs.

Figure 16 - Use of Risk Capital for Equity Investments and above cut-off operations



6.5 Compliance with Operational limits - To ensure adequate diversification of its portfolio; the Bank applies five principal exposure limits for non-sovereign lending operations. As indicated in Table 03 none of these limits has been breached.

Table 03 - Risk Capital limits as at 30 September 2011

	Limit	As Share of	Current highest used risk capital levels
Equity Limit	15%	Of Total Risk Capital	9.2%
Single Country	25%	Non-Sovereign Risk Capital	5.6%
Single Sector*	25%/35%*		16.3%
Single Obligor	6%		1.9%
High risk limit	10%		5.0%

*25% for other industries and 35% for financial institutions.

MAIN CHANGES TO GUIDELINES AND METHODOLOGIES FOR CREDIT RISK MANAGEMENT

The Bank's Non-Sovereign Credit Risk Management Guidelines

6.6 The guidelines that document credit principles and processes for identifying, assessing, controlling, reporting and managing credit risk have been reviewed to reflect not only new developments in the Bank's operating environment and growing complexity but also recent changes in the strategies governing the Bank's operations²⁷. Further developments are underway to accommodate events or changes foreseen in the near future, such as (i) changes to Economic Capital framework and the Expected Loss approach in risk measurement, (ii) Basel III and implications for existing frameworks; and (iii) Changes to relevant International Financial or Credit Reporting Standards.

Development of methodologies for assessing credit risk concentration and managing equity portfolio

6.7 In 2011 the Bank continued to refine its methodologies to measure credit risk concentrations within its loan portfolio. The methodology adopted is based on the same approach used when defining capital allocations for credit risk but factors systemic and contagion risk. Also, in response to external auditors' concerns on the pace of growth and associated risk in the

²⁷ These are essentially Risk Appetite, New Private Sector Development instruments, Revised Exposure management framework, and Collateral management, Optimization of both sovereign and non-sovereign rating models and processes.

equity portfolio, the overall framework for private equity fund's management has been revamped.

Risk pricing policy for non-sovereign operations

6.8 As part of the GCI-VI commitments, Management undertook to review the non-sovereign pricing framework. A proposal has been submitted to ALCO for approval. Through the risk-based pricing²⁸ the Bank seeks to balance its objective of being competitive in the private sector market place with the need to recover the cost of extending risk bearing capacity to its borrowers. The new pricing framework seeks to correct the inadequacies of the existing pricing model as it relates to full recovery of the costs of risks, including concentration risks and recovery of administrative charges. The specific feature of the pricing mechanism is that the total risk premium is calculated as the sum of charges for credit risk and concentration risk²⁹. It introduces a flexible margin in the pricing structure to enable the Bank to adapt its pricing to those of other lenders and the market in order to maintain its competitiveness. Other revisions relate to the pricing for guarantees and administrative charges. For guarantees, 100% of the credit spread for an equivalent loan will be applied. The administrative charges should now include the total administrative cost associated with Non Sovereign operations and will be reviewed at least annually.

STRENGTHENING THE BANK'S RESILIENCE TO SHOCKS

Enhance Quality at Entry of Transactions in the Portfolio

6.9 Quality at entry is central in the gradual rebalancing of the portfolio in terms of risk structure. Ensuring quality at entry, particularly when the Bank is called upon to lend more to LICs and FS, requires a proper screening of deals through adequate checks and balances in all layers of the existing credit process. It also entails that transactions structuring should factor lessons learned from the multiple waivers granted after the approval of the projects by the Board. Accountability of risk takers for quality at entry cannot be overemphasized, but goes with the decentralization/transfer of front-line risk management function and risk assessment tools to investment officers. Moreover, given the growing level of cancellations, a solution needs to be found to the “*approval culture*” through institutional KPIs.

Strong Pipeline Development

6.10 The volatility in the Indicative Operational Program - IOP (as results of drop, cancellation, postponement, etc.) as well as the waivers indicate that significant effort is needed to build a strong reserve of projects, ensure early evaluation before the approval year and improve the project structuring. A pipeline development index should be embedded in the IOP preparation and development.

Adequate Supervision

6.11 Both rating agencies and external auditors concurred that given the level of DRE risks in the portfolio and high nonperforming loans when compared to other MDBs and the current volatile environment with rapid changes in rating, the Bank's portfolio should be more actively supervised. This will allow taking corrective actions more quickly and protecting the Bank against losses.

²⁸ In this framework, the Bank's cost of extending its risk bearing capacity (in the form of lending to obligors), provides a 'risk-based' benchmark for determining the lending spread for the facility

²⁹ The concentration and correlation effects generated by the dependence of credit exposures on common risk factors which caters for the contribution to the portfolio concentration risk

DEVELOPMENT OF INNOVATIVE LENDING INSTRUMENTS

6.12 The growing challenge of fulfilling the Bank's development goals while preserving its financial solidity and credit rating, calls for the introduction and development of innovative lending and risk management techniques. The experience gained over the last years in syndication will allow the Bank to actively leverage the development impact of the risk capital allocated to non-sovereign operations by mobilizing financing from commercial sources and other IFIs³⁰.

6.13 Another significant development is the establishment of an African Trade Finance Risk Sharing Facility (ATFRSF), which involves the share of risk agreement (between the Bank and commercial banks) to promote trade in strategic areas such as fragile states or intra-African trade as well as the opportunity to operate with longer tenors.

The Initiative of Risk Management in Africa (IRMA) currently under implementation is likely to also contribute to the development of risk management products.

INSTITUTIONAL GOVERNANCE OF RISK AND RISK INFRASTRUCTURE

6.14 Unlike other MDBs, the Bank carries a single balance sheet with two portfolios (sovereign and non-sovereign) with an increasing share of unsecured non-guaranteed lending, which call for strong risk management governance and structures. The Board approved in May 2011 the Bank's Risk appetite statement, including the establishment of a Credit Risk Committee to strengthen the institutional governance of risk. This provides, amongst others, for an end-to-end credit risk governance structure and a streamlined approach in making a specific credit recommendation to OpsCom. However, key enablers to the implementation of risk committee are a change in risk culture and building risk awareness.

6.15 It continues to be paramount for the Bank to implement an enterprise-level strategy for Risk Management. This will enable the Bank to have a more effective and holistic monitoring of its risk exposures and to meet enterprise-level performance monitoring requirements: Board of Directors, Senior Management and Business Units. This enterprise-wide strategy should take its foundation in the integration and interdependencies of processes and data among Credit, Market and quantitative Operational Risks.

CONTINUOUS DIALOGUE WITH MARKET PARTICIPANTS, RATING AGENCIES AND PEERS.

6.16 Swings in the global economic environment call for the continuation of dialogue with market participants, rating agencies and other sister MDBs in order to build the Bank's resilience and mitigate risks through best practices and information sharing. Management has intensified its interaction with market participants during the recent period, as a result of the shift in the economic environment and the increase in market turbulence.

VII. CONCLUSIONS

7.1 The Bank's portfolio dynamics confirm a return to a moderate growth path in terms of approval and disbursements in tune with the years prior to 2009, when the portfolio experienced a significant growth in response to the financial crisis. At the same time, the share

³⁰ In October 2011, the Bank completed its first commercial co-financing consisting of a USD 810 million facility for Transnet of South Africa, of which USD 400 million A-loan was provided by the Bank for its own account and a USD 410 million B-loan provided by a syndicate of five investors.

of large budget support loans which have traditionally been the portfolio growth driver was reduced.

7.2 Non-Sovereign exposure continues to be the most significant source of portfolio risk for the Bank. Therefore the continued growth of private sector operations calls for emphasis on quality and readiness of projects at entry in the portfolio and enhanced supervision given the volatile and deteriorating credit environment. Furthermore, the equity investment portfolio share in the non-sovereign portfolio continues to record a strong growth rate. This feature of the portfolio requires effective monitoring and embedding exit strategies in new transactions in order to keep the use of risk capital by this instrument within the 15% statutory limit.

7.3 The overall risk profile of the portfolio is good, despite increased risks due to the successive downgrades of North African countries and the deterioration of the credit profile of some private sector borrowers. Most of the exposures are within their prudential limits. The Weighted Average Risk Rating (WARR) remains below the target range of 3.0 and 4.0.

7.4 The ongoing turbulences in financial markets and socio-political transition related developments in several of the RMC borrowers could create some threats and risks to the Bank. Stress testing of the portfolio to systemic risks and other potential extreme events indicates that the Bank has enough risk bearing capacity to absorb shocks. However, the reputational risk could be high and the Bank must be proactive and should strengthen its communication strategy with bondholders, rating agencies and other external stakeholders. Future lending decisions in response to the need to assist RMCs in this difficult environment to achieve inclusive and shared growth should ensure adequate balance between risk and fulfilling development mandate. There is also a need to give priority to build-up reserve during the net income allocation exercise.

7.5 Diversification through: (i) the use of less consuming risk capital products and accessible to a large number of RMCs borrowers (e.g. well-structured trade finance products to existing specialized regional institutions of the continent³¹), (ii) more extensive use of credit substitute, (iii) roll-over of equity investments (through selling-off existing positions and engage in new positions to maintain risk capital allocation within limit), and (iv) hedging of concentration risk (whenever feasible) could help ensure healthy portfolio growth. Greater attention also needs to be paid to the development and management of the pipeline.

7.6 Moreover, the Bank ought to continuously strengthen institutional governance of risk and all internal stakeholders will gain in enabling the implementation of an Enterprise-wide approach to risk management including lending risk.

³¹ Afreximbank, PTA, specialized national banks, etc.

Annex 1 – Internal Rating Framework

The Bank uses three levels of rating scales that are intrinsically related: (i) a 22-point (1 to 22) primary rating scale which is the **master scale**; (ii) a **secondary rating scale** that collapses the 22 grades into 10 grades for easier reporting purposes; and (iii) a **tertiary scale** which corresponds to five broad risk classes to facilitate communication with internal stakeholders.

The ratings are mapped to the international rating agencies scale. A rating of (1) corresponds to A on this international rating scale and the ratings from 6-10 all correspond to CCC to C on the same international scale.

Ratings from 1 to 10 are appended with modifiers that provide greater granularity to identify a strong (+), average or weak (-) rating within each numerical level. (+) or (-) shows the relative standing within major rating categories. The credit exposure is distributed on a condensed rating scale from very low risk to very high risk.

Table A.1 – ADB Internal Rating Scale

	International Rating	Primary rating scale	Secondary rating scale	Tertiary scale
Bankable	A1 and above	1+	1	Very Low Risk (VLR)
	A2	1		
	A3	1-		
	Baa1	2+	2	
	Baa2	2		
	Baa3	2-		
	Ba1	3+	3	Low Risk (LR)
	Ba2	3		
	Ba3	3-		
	B1	4+	4	Moderate Risk (MR)
	B2	4		
		4-		
	B3	5+	5	
		5		
Non-Bankable	Caa1	5-		
		6+		
	Caa2	6	6	
		6-		
	Caa3	7	7	
		8	8	
	Ca	9	9	Very High Risk (VHR)
	C	10	10	

Cut-off rating for non-sovereign operations

The cut-off rating for non-sovereign projects is set at 5 in the non-sovereign operational guidelines.

Any project rated 5- and above can only be approved on an exceptional basis except those located in Fragile States and post-conflict countries or regional projects (covering Low income countries rated higher than 5).

As per external audit requirements an exceptional report has to be provided to the Board for all ratings above the cut-off.