

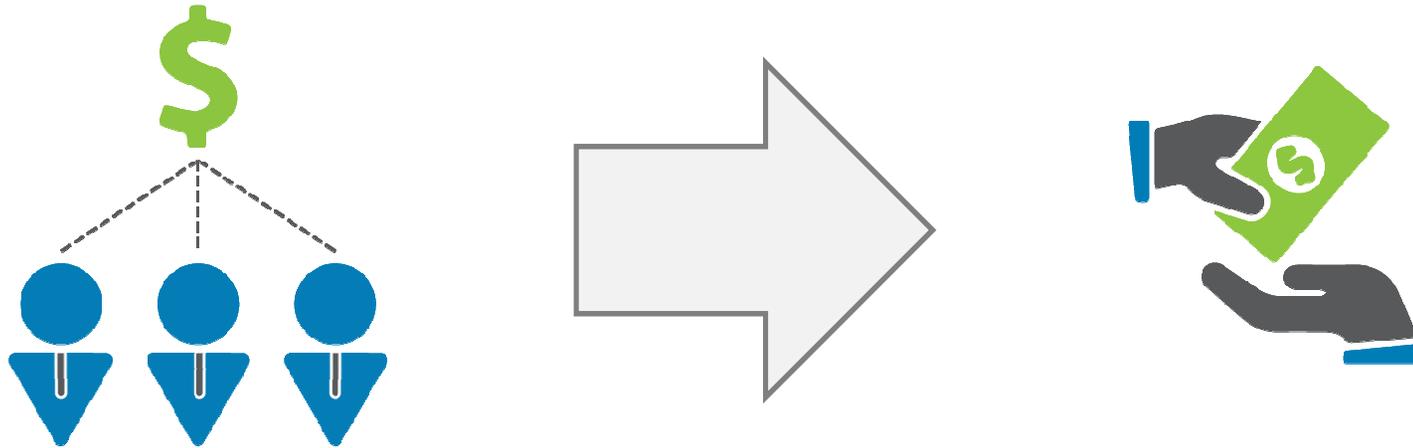
A History of Financial Management at **Asian Development Bank**

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20 April 2017

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ADB Intermediates Resources



Shareholders

Institutional Investor

- Insurance Companies
- Pension Funds
- Banks
- Others

Borrowers

- DMCs
- Non-Sovereign Entities

AAA Rating is the Result of



Shareholder Support

Stand Alone Strength

- Policies
- Protocols
- Operational Profile
- Risk Management
- Asset Liability Management
- Preferred Creditor Status



Defending ADB's AAA Rating



Rating Agencies Must be Convinced

- There is Enough Capital to Cover Risk and Continue as an On-Going Concern
- Net Worth is Protected from Foreign Exchange Risk
- Net Interest Margin is Protected from Fluctuations in Interest Rates
- Sufficient Liquidity is always on Hand to Meet the Needs of ADB Operations



Timeline of Financial Management

First Decade: Watanabe/Inoue (1966-1976):

Establishment, Foundation of Capital Management Policies, “CCCC” Restriction on Borrowings, GCI I, GCI II, First Bond Issue, Oil Crisis, Dollar Off Gold Standard, MOV Debate, ADF Established.

Second Decade: Yoshida/Fujioka (1977-1986): GCI III, MOV Debate, Operational Expansion, ICR/RLR as Key Indicators, Borrowing Expansion, Multi-currency Pool Based Lending Introduced, Exchange Risk Pooling System Introduced, ADF Replenishments

Third Decade: Fujioka/Tarumizu/Sato (1987-1996): GCI IV, Risk Management Enhancements, RLR Enhancements, Market Based Lending Introduced, Increasing Use of Derivatives in Borrowing, ECP Launched, Dragon Bonds, Investment Derivatives Introduced

Timeline of Financial Management

Fourth Decade: Sato/Chino/Kuroda (1997-2006): Asian Financial Crisis, Dot-Com Implosion, Jumbo Emergency Lending, Borrowing Expansion, GDIF Introduction, Introduction of Local Currency Borrowing, Corporate, MBS, ABS Added to Investments, Income Planning Enhancements, Introduction of Risk Based Capital, RMU Set Up

Fifth Decade: Kuroda/Nakao (2007-2016): GCI V, Internal Risk Rating Model Introduced, New Quantitative Risk Metrics, Models, Systems, Procedures Rolled Out, Mortgage Meltdown, Lehman Implosion, RBL Introduction, Project Galaxy



Over 50 Years, Stand Alone Strength Has Helped Weather Many Storms

- 1973 Oil Embargo
- Monetary Turmoil of 1970s
- BCCI Collapse
- Orange Country Bankruptcy
- Barings Collapse
- Asian Financial Crisis
- Dot-Com Meltdown
- Mortgage Market Collapse
- Lehman Implosion



**C'mon, Doesn't ADB Just Follow the
World Bank?**

Ah, No.....



ADB's Stakeholders in Promoting Economic and Social Development

- **Shareholders**
 - Sustainable Development Financing while Preserving Capital
- **Bondholders**
 - Safe, Stable and Preferably High Rates of Return on Funds Invested
- **Borrowers**
 - Low Cost Development Assistance

How to Lend to Lower Income Borrowers and still Maintain AAA rating?



The Financial Management Framework

- Policies
- Metrics
- Protocols
- Procedures to Ensure Stand-Alone Strength



Two Important Themes



Capital Management



Risk Management

Capital Management



- **Ultimate Source of Solvency**
- **Absorbs Potential Losses on Risk Assets**
- **Important for Bond Holders: Source of Credit Worthiness**
- **Key Determinant of Level of Loans, Guarantees, Equity Investments and Borrowings**
- **Generates Income**
- **Paid-In Equity, Reserves, Surplus**

How Much Capital? Well, How Much Risk?

- **Most Significant Risk:**
 - Default or Protracted Non-Accrual Status on Large Part of Loan Portfolio
- **Covering Risk**
 - **Expected Loss**
 - Provisions to Income and Loan Loss Reserves
 - **Unexpected Loss**
 - Income Generating Capacity and Capital



Why Should an MDB Maximize Income? (Subject to Risk Constraints)

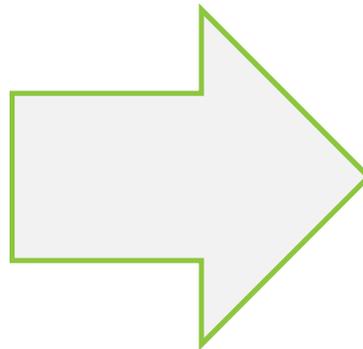
- **Net Income Management has a Direct Impact on Risk Bearing Capacity**
- **Two Principal Earning/Risk Assets**
 - Loans
 - Investment Portfolio
- **Income Generated Can be Allocated to Capital Through Reserves**
- **Income and Reserves Policy were at Core of Capital Adequacy Management for Many Years**



Capital Management Evolution

Previous

- **ICR** (Interest Coverage Ratio)
- **RLR** (Reserves to Loan Ratio)



Current

- **Risk Based Capital**
- **Default Probabilities**
- **Simulation Analysis**
- **ELR (Equity Loan Ratio)**



Crisis Sometimes Drives Change

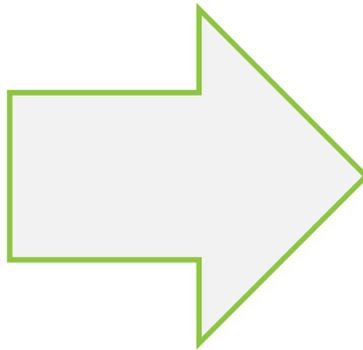
- Introduction of LIBOR based Lending
- Introduction of Local Currency Lending
- Helping Borrowers Address Mismatch Risks



Risk Management

Previous

- Silos
- Static



Current

- Integrated
- Dynamic
- Use of Default Probability Models

Financial Risk



- Credit Risk
- Market Risk
- Counter Party Risk
- Liquidity Risk
- Operational Risk
- Legal Risk
- Settlement Risk
- Others (e.g. Concentration)

Managing for Financial Risk

- **Sovereign Book**

- Provisions based on future repayment projections
- Loan Loss Reserves based on Average Loss from Historical Default Experience

- **Non-Sovereign Book**

- Provisions based on future repayment projections
- Loan Loss Reserves based on Probabilities of Default, Loss Given Default, Recovery Ratios

- **Treasury Assets**

- Issuer Restrictions
- Counterparty Restrictions
- Interest Rate Risk Restrictions

Technology



- **Models and Systems Enabled Increased Sophistication in the Identification, Measurement and Management of Risk Over the Last 50 Years**
- **ADB Has Been Able to React More Efficiently and Effectively to Crisis Over Time**
- **Integration Nirvana?**

Lessons Learned and Food for Thought



- **Notwithstanding Project Galaxy, Appropriate Financial Management will Remain a Key Determinant of ADB's Ability to Intermediate Effectively**
- **Application of Increasingly Sophisticated Risk Metrics and Protocols will Enable a General Expansion in Operations**

Lessons Learned and Food for Thought



- **Future of Risk and ADB's Ability to Manage It**
- **Evolution of Borrower Requirements**
- **Basle 4 and Other Regulatory Hurdles**
- **We Must Avoid the Comfort of Risk Aversion**