TECHNICAL REPORT

Summary of Credit Risk Management Policies and Processes for Private and Public Sector Operations

Support to the Sahel and West Africa Regional Programs Project

SUBMITTED TO
USAID, West Africa Regional Program

UNDER CONTRACT NO.
PCE-I-09-98-00016-00

SUBMITTED BY
Nathan Associates Inc.
Arlington, Virginia

January, 2002

USAID

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INTRODUCTION

The Ecowas New Financial Group (ENFG) is in the process of establishing and executing various policies and procedures to reduce or limit exposure to risks assumed in the normal course of providing commercial and development ENFGing services. Such proposed policies and processes will reduce the ENFG's exposure to interest rate, currency, liquidity, legal, and operational risks. It will at the same time maximize its capacity to assume the risks of extending credit to its public sector and private sector clients within its approved risk limits.

PUBLIC SECTOR CREDIT RISK

The single largest source of risk for the ENFG is the potential default of its public sector borrowers. Its approach to managing this credit risk will from now on include a rigorous assessment of the default risk of its borrowing member countries through an annual country rating exercise that will classify such borrowing member countries on a five-point internal credit risk rating scale. The ratings will be used to determine the maximum sustainable credit ceilings for the member countries eligible to borrow from the ENFG ’s window.

The ENFG will maintain a prudent distribution of its public sector portfolio through its exposure management policies. For each eligible public sector borrower, the ENFG will apply an exposure limit that reflects the country's risk rating and its economic potential subject to a maximum loan equivalent exposure for any single country that ***will not exceed 15%*** of the ENFG' s maximum sustainable portfolio[1]. The country exposure limits will be reviewed annually and will be used as a risk-based benchmark to plan the ENFG's medium-term country assistance strategies.

ENFG' s proposed policy would be that if a payment of principal, interest or other charges with respect to a commercial base rate or subsidized development loan becomes 30 days overdue. In addition, no new loans to that member country, or to any public sector borrower in that country will be approved, nor will any previously approved loan be signed, until all arrears are cleared. In addition, disbursements on all loans to or guaranteed by that member country are suspended until all overdue amounts have been paid. Exceptions could be considered after successful negotiation of debt equity swaps as would be solely elected by ENFG.

Further, for qualifying loans, the granting of commitment fee waivers of 0.50% on undisbursed balances would become contingent upon satisfactory payment performance. Further, the ENFG

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1 The maximum sustainable portfolio and the disbursed and outstanding portfolio are equal when the ENFG's lending operations have fully consumed the ENFG's risk capital according to the proposed capital adequacy policy.

would make a general provision for the expected losses in its public sector portfolio that reflects its assessment of the collectibility risk inherent in the portfolio. In recognition of the estimated portfolio collectibility risk in 2001, the ENFG would set an accumulative general provisioning rate as a (6.25%?) percentage of the total disbursed and outstanding public sector loans in 2001.

To cover potential unexpected credit related losses due to extreme and unpredictable events, the ENFG would maintain a conservative risk capital cushion for public sector credit risks.

The ENFG' s capital adequacy proposed policy would articulate differentiated risk capital requirements for all public sector credit-sensitive assets (loans and equity investments) plus contingent liabilities (guarantees and client risk management products) in each risk class. At the end of 2001, the ENFG' s public sector portfolio used up approximately (77%?) of the ENFG' s total on-balance sheet risk capital (paid-in capital plus accumulated reserves plus general provisions). The ENFG will take a prudent approach to measuring capital adequacy for operational planning and would not include callable capital or subordinated debt in its computation of its risk capital.

PRIVATE SECTOR CREDIT RISK

Another source of risk for the ENFG is the potential default of its private sector borrowers. The ENFG' s approach to managing this credit risk would start with a rigorous appraisal of new loan proposals and continues with quarterly assessments of the default risk of each outstanding private sector loan. To ensure a prudent distribution of its private sector loan portfolio, the ENFG would generally limit its exposure in any single project to the lesser of one third of the total project financing cost or 5 million UAs. These limits may be exceptionally waived for large infrastructure projects and investment funds. To partially mitigate the credit risk for direct private sector loans (assessed on cash flow generated by the project), the ENFG generally would require a range of securities and guarantees from the project sponsors.

To cover the expected losses in the performing private sector portfolio (ratings 1 to 6), ENFG would make a general provision between 2% and 15% of the total loan equivalent exposure based on individual project risk ratings. For non-performing projects (ratings 7 to 10), ENFG would make a specific provision based on an assessment of the credit impairment of each project.

In addition to lending, the ENFG could make equity investments in private sector projects. In cases where the equity investment is assessed as potentially non-performing the ENFG would make a provision based on accepted impairment tests measured against ENFG's carrying cost.

For investment funds in the early stage, the ENFG would make provision in increments of 25% based on an assessment of actual performance versus the ENFG expectations at the time of approval.

To cover potential unexpected credit related losses due to adverse and unpredictable events, ENFG would maintain a conservative risk capital cushion for private sector credit risks. The ENFG' s capital adequacy policy would articulate differentiated risk capital requirements for all credit sensitive private sector assets (loans and equity investment plus contingent liabilities (guarantees and client risk management products) in each risk class. At the end of 2001, the ENFG' s private sector portfolio used up less than 2% of the ENFG' s total on-balance sheet risk capital.

COUNTER PARTY CREDIT RISK

In the normal course of its business, the ENFG would utilize more diversified financial instruments to meet the needs of its borrowers, to manage its exposure to fluctuations in market interest and currency exchange rates, and to temporarily invest its liquidity prior to disbursement. All of these financial instruments involve, to varying degrees, the risk that the counter party the transaction may be unable to meet its obligation to ENFG.

To reflect a preference for minimizing exposure to counter arty credit risk, the ENFG would maintain eligibility criteria that limit the ENFG' financial operations to counter parties with the very best credit ratings. For example, the minimum rating for counter parties for derivative instruments would be AA.

In addition to these stringent rating standards, ENFG would operate a framework of exposure limits based on the counter party credit rating and size subject to a maximum of 10% of ENFG' s total risk capital for any single counter party. Individual counter party credit exposures would be aggregated across all instruments using the ENFG for International Settlements (BIS) potential exposure methodology and monitored regularly against ENFG' s credit limits. As a rule, the ENFG would execute an International Securities Dealers Association (ISDA) master agreement and netting agreement with its derivative counter parties prior to undertaking any transactions.

To protect against potential unexpected credit related losses due to unpredictable adverse events, ENFG would maintain a conservative risk capital cushion for counter party credit risks as per the current BIS standards. ENFG's counter party credit portfolio should require as backing, less than 1% of ENFG's total on-balance sheet risk capital.

LIQUIDITY RISK

The ENFG should holds sufficient liquid assets to enable it to continue normal operations even in the unlikely event that it is unable to obtain fresh resources from the capital markets for an extended period of time. Each year the ENFG computes a prudential minimum level of liquidity based on projected net loan disbursements plus contingent liabilities and debt service payments averaged over two years. In addition, the prudential minimum level of liquidity includes all potential debt service payments due to early redemption of swaps and borrowings with embedded options. To enable the ENFG to take advantage of lower-cost funding opportunities as they arise, the ENFG's policy would permit an increase of liquid resources up to an operating level equal to the total of the prudential minimum, including undisbursed and irrevocable commitments.

To strike an optimal balance between generating adequate returns from investing liquid assets and holding securities that can be easily liquidated when the need arises, the ENGF would divide the investment portfolio into tranches with different liquidity objectives and benchmarks. To cover its expected operational cash flow needs, the ENFG would maintain an operational tranche of liquidity that would always be invested in the most highly liquid securities. Probable redemptions of swaps and borrowings with embedded options are included would be included in the computation of the size of the operational tranche of liquidity.

CURRENCY RISK

The agreement establishing the ENFG explicitly prohibits it from taking direct currency exchange exposures by requiring liabilities in anyone currency (after swap activities) to be matched with assets in the same currency. This is achieved primarily by holding or lending the proceeds of its borrowings in the same currencies in which they were borrowed (after swap activities) To avoid creating new currency mismatches, the ENFG requires its borrowers to service their loans in the currencies disbursed. However, to facilitate loan repayment for its borrowers that may not have easy access to certain currencies, the ENFG would provide under the proposed policy currency purchase services on an agency basis.

Because a large part of its balance sheet is funded by equity resources denominated in Units of Account, the ENFG has a net asset position that is potentially exposed to translation risk due to currency exchange fluctuations. The ENFG's policy is to minimize the potential fluctuation of the value of its net worth measured in Units of Account (equivalent to the SDR) by matching the currency composition of its net assets with the currency basket of the SDR.

The distribution of the currencies of the ENFG's recurring administrative costs shows a high concentration of expenses in Euros and CFA. The ENFG should seek to mitigate the unfavorable impact of a potential rise in the value of the Euro by purchasing call options on the Euro to cover the estimated amount of Euro and Euro-related expenses for the fiscal year.

INTEREST RATE RISK

Under the proposed policy there would be two principal sources of interest rate risk for ENFG. The first would be the interest rate sensitivity associated with the net spread between the rate ENFG would earn on its assets and the borrowings, which fund those assets.

Under the proposed policy ENFG should begin began offering "variable rate loans" whose interest rate would reset quarterly or semi-annually based on the average cost of a dedicated pool of ENFG' s borrowings.

These pools are funded with a mix of fixed rate and floating rate borrowings to provide borrowers with broadly stable interest rates that gradually track changes in market interest rates. The cost of funds pass-through formulation incorporated in the lending rates charged on ENFG' s pool-based loans would help to minimize the interest rate sensitivity of the net spread on this part of its loan portfolio.

ENFGs could also offer fixed and floating rate loans whose interest rate is directly linked to market interest rates. For the market-based loan products, ENFG' s net margin would be preserved by using swaps to align the interest rate sensitivity of the loans with that of ENFG' s underlying funding (three and six-month Libor floating rate).

Under the proposed policy ENFG should also provides borrowers with risk management products such as swaps to modify the currency and interest rate terms of its market-based loan products. Although it should prefer to retain the credit risks, ENFG would safeguard the intermediation fee it earns on risk management products by simultaneously laying off the market risks with an approved derivative counter party.

For the portfolio of liquid assets, ENFG would protect its net interest spread by managing its investments within duration mismatch limits around benchmarks that replicate the interest rate characteristics of the underlying funding for each proposed portfolio tranche.

The portfolio of liquid assets would be divided into three tranches to reflect the different business purposes and underlying funding. The core part of the investment portfolio would be held to comply with ENFG' s liquidity policy and would use a six-month Libor floating rate benchmark.

The operational portfolio would be managed to meet projected operational cash flow needs and would use a one-month Libor floating rate benchmark. In some currencies, liquidity would be partially funded by ENFG' s equity. For these portfolios ENFG would use a recognized 1-3 year fixed income bond index as its performance benchmark.

Under the proposed policy the ENFG would seek to diversify the sources of its funding by issuing debt in a variety of markets and instruments. Unless fixed rate funding is required for one of its pool-based loan products, ENFG would manage its net interest margin by simultaneously swapping all new borrowings into floating rate in one of the ENFG active currencies on a standard six-month Libor rate reference. Where the ENFG issues debt with embedded options, ENFG would simultaneously enter into a swap with matching terms to synthetically create the desired six-month Libor-based floating rate funding. For interest rate management purposes, callable funding is considered as one alternative to issuing short-term debt such as Euro Commercial Paper.

Under the proposed policy the second principal source of interest rate risk would be the interest rate sensitivity of the income earned from funding a portion of ENFG's assets with equity. Changes in market interest rates in ENFG's active currencies would largely determine the net income earned on loans funded by equity. In general, lower nominal interest rates result in lower lending rates, which in turn reduce the nominal earnings on ENFG's equity.

In addition to these two principal sources of interest rate risk, ENFG would be exposed to prepayment risk on the parts of its loan portfolio issued before 2002 under the existing policy. Although ENFG is unable to charge a prepayment penalty on these older loans, in practice the level of prepayments has been relatively limited. Under the proposed policy for all market-based loans, ENFG would protect itself from prepayment risk by linking the prepayment penalty to the cost of redeploying the funds at current market rates.

OPERATIONAL RISK

ENFG, like all financial institutions, is exposed to many types of operational risks including the potential losses arising from internal activities or external events caused by breakdowns in information, communication, physical safeguards, business continuity, supervision, transaction processing, settlement systems and procedures, and the execution of legal, fiduciary, and agency responsibilities. In addition to establishing a credit department, ENFG should maintain a comprehensive system of internal controls at the holding level. These would be designed to keep operational risk at appropriate levels in view of ENFG' s financial strength and the characteristics of the activities and markets in which it operates. These internal controls are periodically updated to conform to industry best practice.

RISK MANAGEMENT PROCESS

The processes and procedures by which the ENFG manages its risk profile should continually evolve as its activities change in response to market, credit, product, and other developments. The highest level of risk management is carried out by ENFG' s Board of Executive Directors. In addition to approving all risk management policies, the Executive Directors periodically ought to review trends in the ENFG' s risk profiles and performance to ensure compliance with those policies.

RISK MANAGEMENT OVERSIGHT ROLE AT HOLDING LEVEL

The risk management oversight should be done for the group once a month under the supervision of the holding: the Banque d'Investissement et de Developpement de la CEDEAO (BIDC) due to the fact that:

- BIDC has a majority control in both subsidiaries Banque Regionale d'Investissement de la CEDEAO (BRIC) and of the Fonds Regional de Developpement de la CEDEAO (FRDC). This entails a line-by-line consolidation of all country and sector limits and Clients.
- The relative small sizes of the will necessitate that all support units be kept at the holding level in order to achieve economies of scale.

Consequently the assets and liabilities management committee ought to be kept at holding level. This committee supported by a risk management unit, as advisor, and six standing working groups (the Country Risk, Private Sector Provisioning, Financial Products, Currency Management Funding Management, and Financial Projections), that report to the committee on specific financial and risk management issues. The day-to-day operational responsibilities for implementing the Bank's risk management policies would be delegated to the relevant business units.

Private Sector Risk Management

INTRODUCTION

Development impact and the resulting effect on poverty alleviation drive the ECOWAS' lending operations. However, to preserve the long-term financial viability of the New Financial Group, it is equally important that each investment decision contributes towards the development of a sound portfolio. This report summarizes the principal credit risk management policies and processes employed by the New Fund Affiliates to ensure the development of a sound private sector portfolio.

CREDIT RISK ASSESSMENT

Risk Rating Methodology

Before credit risk can be managed, it must be ***measured***. The New Fund Affiliates employ a ten-point credit risk rating scale to measure the expected loss of each credit facility[2] as illustrated in table 1 below. As a measure of expected loss over the tenor of each facility, the New Fund Affiliates' credit risk ratings integrate assessments of both the cumulative default probability[3] for each borrower as well as the estimated loss given default of each specific credit facility.

The New Fund Affiliates' credit risk ratings can be collapsed into five generic risk classes from very low risk to very high risk that coincide with the risk profiles of the New Fund Affiliates' potential clients. The New Fund Affiliates' risk ratings are intended to correspond broadly to the international credit rating scales as shown in Table 1.

Table 1. ECOWAS Credit Risk Rating Scale

Risk	Description	Expected Loss	Risk Score	Risk Class	International Equivalent
1	Excellent	2%	> 79	Very Low Risk	BBB/Baa
2	Strong	3%	70- 79	Low Risk	BB/Ba
3	Good	4%	65-69 .	Moderate Risk	B/B
4	Fair	6%	60-64		
5	Acceptable	8%	55-59	High Risk	CCC/Caa
6	Marginal	15%	50-54		
7	Special Attention	30%	45-49		
8	Substandard	50%	40-44	Very High Risk	CC-D/Ca-D
9	Doubtful	80%	35-39		
10	Expected Loss	100%	<35		

Note:Rating scales used by Standard & Poors and Moody's Investors Service.

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2 One borrower or client may have different facilities or transactions with the ECOWAS.

3 Default is said to have occurred if payment is more than 30 days overdue.

Although the New Fund Affiliates' credit risk ratings are defined as a generic measure of expected loss, credit risk ratings are assigned to each credit facility based on a scoring system that allocates points from 0 to 100 (100 is the best possible score) as shown in table 1. Private sector credit facility scores are determined in three basic steps as described below.

Step 1 – Analysis of Financial Strength

The starting point for assigning a credit risk rating to a transaction is the analysis of a client's fundamental financial strength. Although the relative importance of the principal financial strength measures varies from industry to industry, generally the analysis focuses on three broad sets of indicators:

- liquidity indicators
- profitability indicators
- leverage / debt service indicators

For each component, financial strength is measured against a range of benchmarks that include industry averages, industry leaders, and recent trends. A raw score on the scale of 0 to 100 is established from a composite assessment of the financial strength indicators.

Step 2 – Obligor Rating Adjustments

Following the assessment of financial strength, four principal obligor risk control factors are used to adjust the raw risk score. The relative importance of these four control factors varies from industry to industry and for existing companies and start-up operations.

- ***Information quality*** -uncertainty about the reliability of the financial information can result in a downward adjustment of the risk score.
- ***Management*** -weaknesses in the management can result in a downward adjustment of the risk score.
- ***Industry*** -the industry and the client's position in the industry generally put a cap on the best possible risk score.
- ***Country risk rating*** -the private sector risk rating of the host country generally acts as ceiling for the risk score.

Step 3 – Facility Rating Adjustments

After adjusting the risk score for obligor risk control factors, the score is further adjusted by four facility risk control factors. The relative importance of these four control factors varies from transaction to transaction and for existing companies and start-up operations.

- ***Third party support*** -the presence of guarantees or other third party support can enhance the risk score.
- ***Facility term*** -longer maturity facilities have higher risk profiles and therefore bring down the risk score.
- ***Facility structure*** -seniority and/or properly structured covenants and conditions can provide risk mitigation effects to improve the risk score.

- ***Collateral*** **-**the quality and coverage of collateral is considered for its benefit in reducing the severity of loss given default and may substantially alter the risk score.

Risk Rating Process

The risk rating process begins as soon as a transaction enters the New Fund Affiliate's project pipeline. The investment officer prepares a preliminary evaluation note with the information required to make a preliminary rating. After reviewing the preliminary evaluation note and any additional information in the transaction file the credit officer scores the facility and assigns a preliminary risk rating. As the appraisal progresses, the risk rating is adjusted as necessary until a final facility rating is confirmed prior to final negotiations. Using the quarterly reviews prepared by the project officers, all risk ratings are jointly reviewed by the investment officers and the credit officers. The updated facility risk ratings are examined at the quarterly portfolio review meeting of the Private Sector Operations Committee (PSOC) and reflected in the quarterly private sector portfolio status report.

Country Risk Ratings

The country risk ratings, which serve as inputs into the transaction ratings, are reviewed in the first quarter of each year. The annual country risk rating exercise is coordinated by the Risk Management Unit through the Country Risk Working Group of the Asset and Liability Management Committee (ALCO). The principal instrument of the annual rating exercise is a survey of the New Fund Affiliates' public sector and private sector country experts. The responses to the annual questionnaire are blended using standardized weightings to produce a public sector and private sector risk score and rating for each country.

EXPOSURE MANAGEMENT

Extending credit entails taking risk. However, the magnitude of the risk can be controlled by limiting the extension of new credit to projects that meet specific minimum risk standards and by avoiding excessive portfolio concentration in single projects or groups of projects that could be simultaneously effected by similar exogenous events. The process of controlling potential losses in a portfolio is exposure management.

The losses in a portfolio of credits can be divided into two broad categories: ***expected losses*** and ***unexpected losses***. Expected losses are the statistically probable level of losses associated with a given risk class. Higher risk classes have a higher expected level of losses due to the combination of a higher probability of default and/or a lower expected recovery of amounts due after default. The New Fund Affiliates anticipates a level of expected losses compatible with the risk profile of its portfolio and compensates for them by making provisions in advance

Unexpected losses are the losses in a portfolio due to systemic or exogenous events. As described below, the New Fund Affiliates protects its self from unexpected losses by diversifying its portfolio wherever possible and by maintaining a conservative level of risk capital to cushion against even low probability loss-producing events.

Risk Capital Requirements

Risk capital is the principal source of the New Fund Affiliates' on-balance sheet risk bearing capacity[4]. Risk capital is composed of three elements:

- Paid-in capital
- Accumulated retained earnings
- General provisions

As the New Fund Affiliates extends credit or invests, it sets aside risk capital to provide an economic cushion against unexpected loss-producing events. For loans or guarantees, the amount of risk capital required is a function of the riskiness of the facility and is expressed as a percentage of the net loan-equivalent exposure of the facility[5] as described in table 2 below. For all equity investments (regardless of the client risk rating [6]), the New Fund Affiliates' risk capital requirement is 100% of the net outstanding amount.

Table 2. Risk Capital Requirements[8]

Risk Rating	Risk Class	Risk Capital Requirement
1	Very Low Risk	25%
2	Low Risk	28%
3 4	Moderate Risk	35%
5 6	High Risk	50%
7 8 9 10	Very High Risk	75%
All ratings	Equity	100%

3.2 Global Limits

The New Fund Affiliates manage credit risk at the global level (combined public and private sector operations) by ensuring that the total amount of outstanding credit does not exceed the maximum sustainable portfolio, where the maximum sustainable portfolio is the largest aggregate portfolio that the The New Fund Affiliates' risk capital can prudently support.

Within the global lending constraint of the maximum sustainable portfolio, the New Fund Affiliates controls credit risk for private sector operations by limiting the amount of risk capital available to support private sector operations to 20% of the New Fund Affiliates' total risk capital. ***(Proposed Policy)***

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4 Tier 1 capital as defined in the Basel Accord on Capital Adequacy. It does not include callable capital.

5 The loan-equivalent exposure of a guarantee equals the net present value of the guarantee.

6 Equity ratings differ from credit facility risk ratings in that the focus of the equity rating is the soundness of the financial fundamentals of the company.

3.3 Benchmark Risk Profile

To enable it to borrow funds at the most competitive rates in the international capital markets, the New Fund Affiliates manage the overall risk profile of its credit portfolios with the objective of protecting its AAA credit rating. To achieve this objective, the New Fund Affiliates seek to build a private sector portfolio whose credit risk profile meets or exceeds the risk standards set by the public sector portfolio. The benchmark credit risk profile, against which private sector portfolio development is measured, is presented in the table below**. *(Proposed Policy)***

Risk Class	*Very Low*	*Low*	*Moderate*	*High*	*Very High*
Portfolio Share	15%	30%	40%	15%	0%

3.4 Country/Sector/Client/Instrument Limits

To control the New Fund Affiliates' exposure to systemic or other default events, the New Fund Affiliates seek to build a portfolio that is adequately diversified in terms of its country , sector, instrument, and client distribution. This is achieved through a combination of global and private sector exposure limits.

Country Limits

At the global level, the combined amount of outstanding exposure to the private and public sector in a given country should not exceed the country's global exposure limit. The New Fund Affiliates' global country exposure limits are determined based on two principal factors: country risk ratings and an assessment of each country's economic potentia19.

Within the constraint of the New Fund Affiliates' global country exposure limits, the total risk capital used for private sector operations in any single country should not exceed 15% of the maximum total risk capital available for private sector operations**. *(Proposed Policy)***

Sector Limits

The total risk capital used for private sector operations in any single sector should not exceed 25% of the maximum total risk capital available for private sector operations**. *(Proposed Policy)***

For exposure management purposes, 11 broad industry sectors are defined below.

1. Telecommunications
2. Power
3. Other Infrastructure
4. Construction
5. Agro-industries
6. Mining
7. Oil and Gas
8. Manufacturing
9. Other Industrials
10. Financial Services
11. Tourism

INSTRUMENT LIMITS

The Agreement Establishing the New Fund Affiliates limits the total amount of equity investments the New Fund Affiliates may make to 10% of total risk capital. Within the constraint of this global equity limit, the amount of risk capital used for private sector equity investments should not exceed 50% of the maximum total risk capital available for private sector operations. ***(Proposed Policy)*** In addition, the New Fund Affiliates cannot be the largest shareholder in a company and its equity exposure should not exceed 25% of the issued capital of an investee company.

The New Fund Affiliates' financial participation in any single project should not exceed 33% of the total cost of the project. ***(Proposed Policy)***

Client Limits

To avoid excessive exposure to any individual obligor, the total amount of risk capital used for any single client (or client business group) in equity investments and/or credit facilities should not exceed 4% of the maximum total risk capital available for private sector operations.

Exposure Monitoring Process

Principal responsibility for understanding and applying the New Fund Affiliates' private sector exposure limits rests with the New Fund Affiliates' private sector investment officers. Private Sector Portfolio Management Group monitors the various exposure and benchmarks and reports to Management on compliance through the quarterly portfolio status report. In addition, the Risk Management Unit provides an independent assessment of compliance with the exposure limits through annual portfolio credit risk review. ***(Proposed Policy)***

PROVISIONING FOR LOSSES

Losses are an inevitable consequence of the New Fund Affiliates' credit extension business. While the New Fund Affiliates' seeks to protect itself from avoidable losses by carefully selecting and managing its projects, prudent financial management requires New Fund Affiliates to make provisions for the losses that are statistically probable portfolio of projects.

Provisioning Requirements

Loans and Guarantees

Provisions for loans, guarantees and other credit facilities can be divided into two broad types: general provisions; and specific provisions. General provisions are a charge to income made in anticipation of a statistically probable level of associated with a given risk rating. If the losses actually achieved are less than the expected losses, the excess of general provisions over actual losses is recovered income.

For projects experiencing difficulties that result in a fundamental weakening of the facility rating to very high risk (7 or worse), the expectation for loss increases sharply. In such cases, the New Fund Affiliates make specific provisions to cover the estimated impairment of the credit facility. If losses are realized, the excess of specific provisions over actual losses is recovered as income.

The New Fund Affiliates make general and specific provisions on the disbursed and outstanding balances of private sector loans, guarantees, and other facilities using the presented in table 3 below.

Table 3. General and Specific Provisioning Rates

Risk Class	Risk Rating	Provisioning Rate
Very Low Risk	1	2%
Low Risk	2	3%
Moderate Risk	3	4%
	4	6%
High Risk	5	8%
	6	15%
Very High Risk	7	Specific (15-40%)
	8	Specific (40-70%)
	9	Specific (70-90%)
	10	Specific (90-100%)

Note: This table outlines the policy on provisioning for private sector operations.

Equity Investments

Unlike loans and guarantees, for which the New Fund Affiliates have limited upside potential beyond the contractual interest margin, equity investments are made with the expectation for much higher returns through dividends and capital gains. To account for the different risk-return profiles of equity investments and credit facilities, the New Fund Affiliates make specific provisions on equity investments when an assessment of likely impairment can be reasonably made.

In the absence of reliable data on earnings multiples or other industry benchmarks, the standard measure of impairment for most equity investments is the net asset test. When the net asset value per share (excluding non-tangible assets) falls materially below the New Fund Affiliates' holding cost, a provision is made for the assessed impairment. For shares that are traded on a recognized exchange or where a valid market price is observable, the market value of the shares can be used to inform a judgment on the degree of impairment.

Investment Funds

When the New Fund Affiliates makes an investment in an equity fund, it makes a long-term commitment with the expectation that the negative returns from the fund in the early years will be compensated by much larger gains as the fund matures. In recognition of the life cycle of investment funds, the accepted approach for provisioning changes as the fund matures.

For early stage investment funds, provisioning is based on an assessment of performance measured against the New Fund Affiliates' original expectations. The principal benchmark for the performance assessment is the investment proposal. The performance of each early stage investment fund is measured against the criteria presented in table 4 below.

Table 4. Early Stage Investment Funds

Assessment Criteria
1. Developments in the target market
▪ Macro-economic
▪ Socio-political
▪ Business environment
2. Management of the fund
▪ Investment implementation
▪ Management effectiveness
▪ Quality of reporting
3. Asset quality
▪ Instrument mix
▪ Problem assets
▪ Provisioning
4. Financial performance
▪ Fund subscriptions
▪ Returns
▪ Dividends

Note: These are guidelines on provisioning for investment funds.

Fund performance is measured on a 5-point scale from "much worse than expected" to "much better than expected". Depending on the severity of the overall assessment of under-performance versus original expectations, provisions are made in increments starting at 25%.

For mature investment funds (essentially fully invested), impairment is assessed like other equity investments using a test of net asset value per share compared to the New Fund Affiliates' holding cost.

4.2 Provisioning Process

Principal responsibility for understanding and applying the New Fund Affiliates' provisioning policy rests with the Private Sector Portfolio Management Group. The Private Sector Portfolio Management Group reports to Management on provisioning through the quarterly portfolio status report. The quarterly portfolio status report is reviewed by the PSOC and presented to ALCO for endorsement and implementation of the provisioning rates. In addition, the Risk Management Unit provides an independent assessment of the adequacy of provisions through the annual portfolio credit risk review.

CREDIT PRICING

In pricing its credit facilities, the New Fund Affiliates seeks to balance its objective of earning an adequate return on capital with the need to be competitive in the private sector market place. To ensure the proper long-term balance between these twin objectives, pricing decisions are influenced by the New Fund Affiliates' cost of extending risk-bearing capacity to its private sector clients.

Periodic Risk Charges

To recover the cost of deploying its risk bearing capacity, the New Fund Affiliates make a periodic internal transfer charge to cover both expected and unexpected losses on all private sector projects. The internal transfer charge for risk is directly linked to the risk rating of each outstanding project in the private sector portfolio and for new credit facilities can be considered as an indication of the minimum risk-based lending margin. ***(Proposed Policy)***

The periodic charge for expected losses is derived from the New Fund Affiliates' provisioning framework and is expressed as an annualized interest margin[7] the disbursed and outstanding balance of each facility. Provisions previously made on amounts reimbursed by the client are recovered as a credit in the period of reimbursement.

The periodic charge for unexpected losses is derived from the New Fund Affiliates' capital adequacy framework and is also expressed as an annualized interest margin on the disbursed and outstanding balance of each project. Reflecting the New Fund Affiliates' development mandate, the periodic risk charge is determined using a cost of the risk capital of only 1% over the cost of debt and a transfer cost of debt at Libor flat[8]. The annualized risk charges for expected and unexpected losses are presented in table 5 below.

Table 5. Annualized Risk Charges

Risk Class	Risk Rating	Expected Losses	Unexpected Losses	Total Charges
Very Low Risk	1	0.40%	0.25%	0.65%
Low Risk	2	0.60%	0.28%	0.88%
	3	0.80%	0.35%	1.15%
Moderate Risk	4	1.20%	0.35%	1.55%
High Risk	5	1.60%	0.50%	2.10%
	6	3.00%	0.50%	3.50%
	7	Specific	0.75%	0.75% + Specific Provisions
	8	Specific	0.75%	0.75% + Specific Provisions
Very High Risk	9	Specific	0.75%	0.75% + Specific Provisions
	10	Specific	0.75%	0.75% + Specific Provisions
Equity	All	Specific	1.00%	1% + Specific Provisions

7 The New Fund Affiliates' provisioning rates are converted into annualized charges using an average 5-year amortization period.

8 The relatively low incremental cost of capital at 1% over the cost of debt is a reflection of the New Fund Affiliates' development finance mandate.

Pricing Process

Principal responsibility for pricing new private sector credit facilities rests with the project officers originating the new transactions. The New Fund Affiliates makes periodic charges for the risk bearing capacity deployed for private sector operations, which are reflected in the regular private sector financial performance reports prepared by the Accounting Department. The effectiveness of the New Fund Affiliates' pricing decisions is regularly evaluated based on the overall financial performance of the private sector portfolio. In addition, the Risk Management Unit provides an independent assessment of the adequacy of the New Fund Affiliates' risk charges to experience through the annual portfolio credit risk review.

Appendix 1. Exposure Limits For 2002

GLOBAL LIMITS

On January 1,2002, the ENFG's total risk capital was UA …..million. At 20% the maximum risk capital available for private sector operations is UA ……. The other exposure limits are linked to the risk capital ceiling as follows:

COUNTRY LIMITS

At 15% of the maximum risk capital available for private sector operations, the single country risk capital ceiling is UA …….. million.

SECTOR LIMITS

At 25% of the maximum risk capital available for private sector operations, the single sector risk capital ceiling is UA……. million.

EQUITY LIMITS

At 50% of the maximum risk capital available for private sector operations, the equity investment risk capital ceiling is UA …..million.

CLIENT LIMITS

At 4% of the maximum risk capital available for private sector operations, the single client risk capital ceiling is UA ……. million.